

California State Auditor

B U R E A U O F S T A T E A U D I T S

Water Replenishment District of Southern California:

*Weak Policies and Poor Planning Have
Led to Excessive Water Rates and
Questionable Expenses*



December 1999
99116

The first copy of each California State Auditor report is free.
Additional copies are \$3 each. You can obtain reports by contacting
the Bureau of State Audits at the following address:

**California State Auditor
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, California 95814
(916) 445-0255 or TDD (916) 445-0255 x 216**

OR

**This report may also be available
on the World Wide Web
<http://www.bsa.ca.gov/bsa/>**

Permission is granted to reproduce reports.



CALIFORNIA STATE AUDITOR

KURT R. SJOBERG
STATE AUDITOR

MARIANNE P. EVASHENK
CHIEF DEPUTY STATE AUDITOR

December 15, 1999

99116

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the Bureau of State Audits presents its audit report concerning the Water Replenishment District of Southern California's (the district) manner of setting assessments and using public funds.

This report concludes that the district has overestimated the amount it needs to collect when it sets the replenishment assessment and does not have a policy to include surplus funds to offset the subsequent year's rates. Further, the district has established \$20 million as its targeted reserve, which we believe is twice the amount justified by the district's projected budgets for the next three years. Thus, not only have the annual assessments been too high, but the district is also maintaining more than it needs in cash reserves. Moreover, the district's process for determining the economic feasibility of one of its capital projects is flawed. As a result, this project may not create the savings the district has anticipated. Finally, the district has not implemented sufficient controls over its administrative functions and spending.

Respectfully submitted,

KURT R. SJOBERG
State Auditor

CONTENTS

<i>Summary</i>	1
<i>Introduction</i>	5
<i>Chapter 1</i>	
The District Overestimates Its Financial Needs When It Sets Annual Assessments for Water Replenishment	13
Recommendations	22
<i>Chapter 2</i>	
The District Poorly Plans and Administers Capital Improvements and Clean Water Projects	23
Recommendations	33
<i>Chapter 3</i>	
The District Has Failed to Adequately Document and Control Administrative Expenses	35
Recommendations	45
<i>Appendix A</i>	
Average Monthly Salaries for Some Positions Are Higher Than At Comparable Agencies	47
<i>Appendix B</i>	
A Uniform Rate Is Required for the Two Basins	49
<i>Response to the Audit</i>	
Water Replenishment District of Southern California	51
<i>California State Auditor's Comments on the Response From the Water Replenishment District of Southern California</i>	73

SUMMARY

Audit Highlights . . .

The Water Replenishment District of Southern California has:

- Consistently overestimated the amount it needs to collect from ratepayers for replenishment and clean water programs.*
- Not taken into consideration unused cash balances to offset replenishment assessments.*
- Maintained excessive cash reserves and cannot explain how much is attributable to capital improvement projects.*
- A flawed process for determining the economic feasibility of its capital projects, which could result in one major project not generating predicted cost savings.*

Furthermore, it failed to maintain controls over administrative functions and spending.

RESULTS IN BRIEF

The Water Replenishment District of Southern California (the district) was established in 1959 to counteract the effects of overpumping of groundwater from two major basins in Los Angeles County, the West Coast and Central groundwater basins. Under its enabling statutes (California Water Code, Section 60000 et seq.), the district has broad powers to perform activities that replenish the groundwater basins or clean up contaminated groundwater. The district is authorized to collect an assessment on groundwater pumped from the basins to pay for its activities. Recently, the entities that pump water from the basins have criticized the district for substantially increasing its assessment and for how it is spending money.

Every year the district overestimates the amount it needs to collect to pay for the water it buys to replenish the groundwater in these two basins. Over the past 10 years, the district has purchased considerably less water than it has estimated it would need. Also, the district has not sufficiently taken into consideration its unused cash balance when estimating how much money it will need to collect through the assessment in a given year. As a result, by June 30, 1998, the district had accumulated approximately \$67 million in its unreserved fund balances. Thus, not only have the annual assessments been too high, but the district also is maintaining more than it needs in its cash reserves.

The district has stated that some part of its cash reserves is needed to fund capital projects related to replenishment and clean water activities. However, it could not tell us how much, if any, of the \$21 million in reserves in the Clean Water Fund and the \$43.5 million in reserves in the Replenishment Fund has been set aside for capital projects. Furthermore, the district's process for determining the economic feasibility of one of its capital projects is flawed. As a result, this project may not save money, as the district originally projected.

Finally, the district has failed to maintain sufficient controls over its administrative functions and spending. Although the district's Administrative Code fails to provide sufficient policy guidance in certain areas, the district's board and district staff

have not always followed the guidance that was provided concerning issues such as contracting. As a result, the district may have spent too much on its contracts. Moreover, it has reimbursed staff members for expenses without documentation that these expenses were work-related. In addition, the district has added new staff positions without providing adequate evidence that they are needed. Finally, we found that the district is obtaining services from 10 lobbying firms in fiscal year 1999-2000, which we believe to be excessive.

RECOMMENDATIONS

The district should amend the way it determines its assessment rate to require that prior year estimates be compared with the actual cost of the replenishment water it purchased and the cost of clean water activities. Any surplus should be used as carryover to reduce the subsequent year's assessment rate.

The district board should reassess its policy regarding a prudent reserve and reduce its target reserve to \$10 million to more closely reflect its budgeted operations.

To improve the means by which it determines the capital expenditure portion of its rate assessment, the district should determine the amount each capital project contributes to the annual rate. The board's resolution adopting the rate should specifically reference these amounts.

To improve its capital improvements projects, the district should:

- Implement and refine a long-term plan.
- Standardize its policies and practices for preparing cost-benefit analyses and for budgeting capital projects.

On the Alamitos Barrier Recycled Water Project, the district should reevaluate the feasibility of this project using a cost-benefit analysis that includes a more reasonable assumption of future water costs.

On the West Coast Basin Desalination Program, the district should move expeditiously to petition the court to clarify the water rights issue since the subsidy from the Metropolitan Water District is dependent on this action.

To strengthen controls over its administrative expenses, the district's board should:

- Reaffirm its commitment to following the policies in its Administrative Code and ensure that its staff abides by its policies.
- Amend and expand its Administrative Code to incorporate additional guidelines related to contracting policies and procedures and limits on the expenses it will reimburse.
- Ensure that a valid contract is in place before paying for contracted services.
- Limit reimbursements to travel within a specific geographic area or require that travel out of the geographic area be brought before the board for specific action.
- Reassess its need for 10 legislative and public advocacy firms.
- Direct its independent auditor, as part of the annual audit, to review the propriety of the district's operating expenses.

AGENCY COMMENTS

The district fully agrees with five of our recommendations, conditionally agrees with two, and disagrees with four. It believes the remaining five recommendations reflect current district policy or practice. It further disagrees with the basis for our analyses and conclusions related to our findings on the district's assessment rate-setting process, its reserve amounts, and the feasibility of the Alamitos Barrier Recycled Water Project. ■

Blank page inserted for reproduction purposes only.

INTRODUCTION

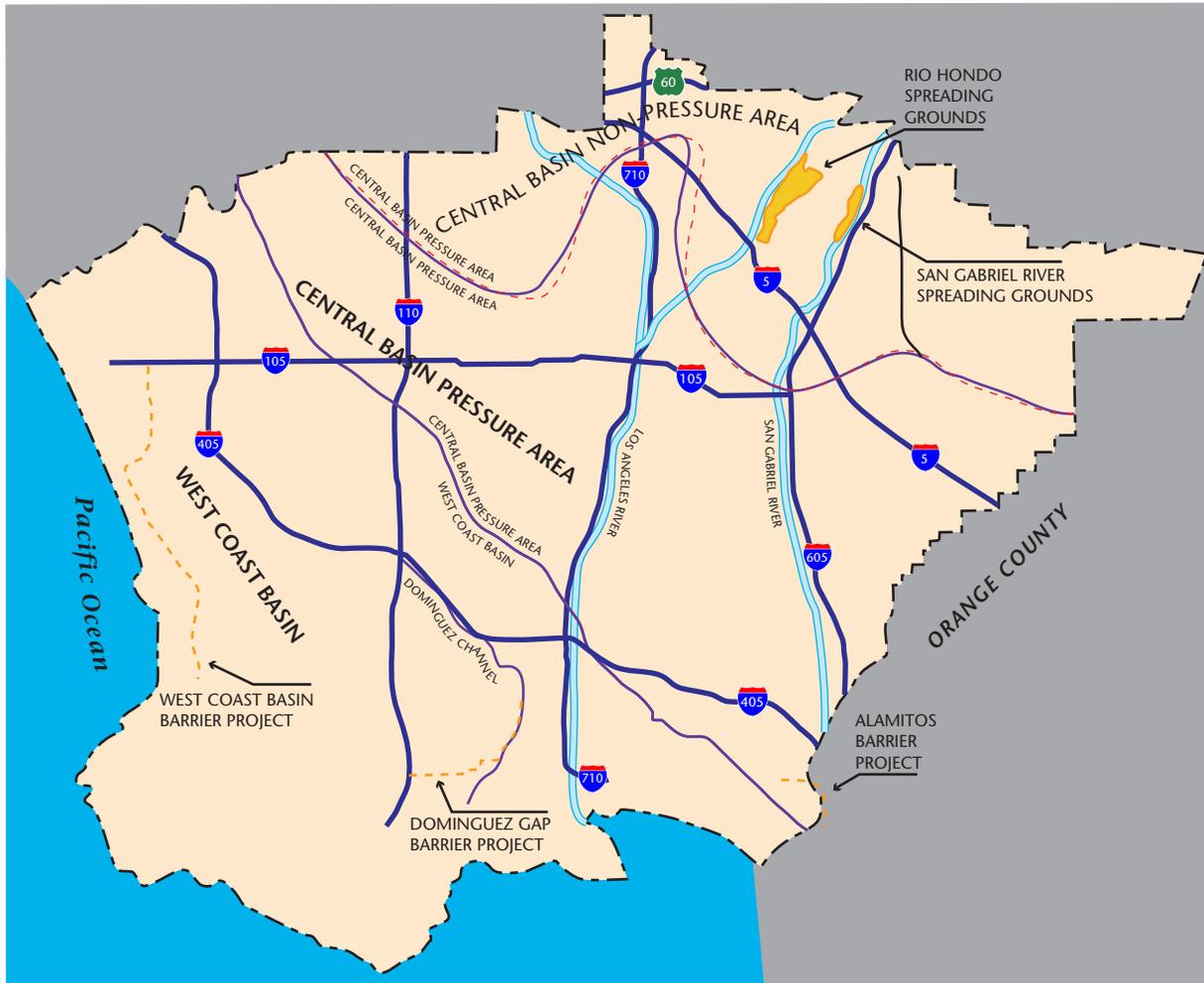
BACKGROUND

The Water Replenishment District of Southern California (the district) is a special water district that was established in 1959 by popular vote to counteract the effects of overpumping of groundwater from two major groundwater basins in Los Angeles County. It is the only replenishment district in California to be set up under the provisions of the California Water Code, Section 60000 et seq., which specifically governs water replenishment districts.

Figure 1 on the following page shows the location of the district. The district is bounded by the Baldwin, Whittier, and Merced Hills in the north, the Orange County line to the east, and the Pacific Ocean to the south and west. It lies entirely within Los Angeles County and serves 43 cities, including Los Angeles, Long Beach, Downey, and Torrance. A five-member board of directors governs the district; each director represents a division of the district. The directors serve four-year terms and are elected at regularly scheduled general elections. The board acts by adopting resolutions. No state or other agency oversees this district.

FIGURE 1

Water Replenishment District of Southern California



Source: Water Replenishment District of Southern California

The district’s stated mission is “to provide a sufficient supply of high-quality groundwater in the Southern California basin through progressive, cost-effective and environmentally sensitive basin management.” Although the district does not directly serve consumers, it ensures the health of the groundwater basins so groundwater supplies are available to those with water rights to those basins, such as the cities that supply water to their residents. According to district estimates, nearly 40 percent of the water consumed by the area served by the district comes from groundwater sources. The rest comes from water imported from the Colorado River and Northern California.

Some entities with rights to pump groundwater from the basins have been increasingly troubled over the past two years by what they perceive as the rapid growth in the number of district staff, large increases in their water replenishment assessment, and questionable administrative expenses incurred by the district. The water replenishment assessment is a fee that these entities pay to the district on every acre-foot of groundwater they pump from the basins. The district, in response to the ratepayers' concerns about its excess funds, created a \$30 million grant program in fiscal year 1998-99. This program allows ratepayers to apply for grants based on the amount of groundwater they pumped during fiscal years 1995-96 through 1997-98. The grant money is to be used for reducing the grantee's reliance on groundwater or for clean water programs.

The district is the defendant in three lawsuits brought by a group of ratepayers and is aware of at least four other potential lawsuits. In August 1999 during the fieldwork stage of our audit, the plaintiffs withdrew one additional lawsuit aimed at halting a district construction project.

THE DISTRICT'S ROLE IS LIMITED TO GROUNDWATER ISSUES

The district originally was established to oversee the replenishment of groundwater levels in the West Coast and Central groundwater basins. The need for an entity to perform this function had become clear by the 1950s. The increasing population of the Los Angeles area during the early part of this century had overwhelmed the area's limited sources of surface water, so communities, private water companies, and businesses began pumping water out of the groundwater basins. Since the natural inflow to the groundwater basins relies primarily on rainfall that averages only 14 inches per year, it was not long before the pumping outstripped the basins' ability to recharge themselves through natural means. As the groundwater levels continued to go down, some wells went dry and saltwater intruded into the basins' coastal areas, causing wells to be abandoned.

The West Basin Water Association was formed in 1946, and the Central Basin Water Association was formed in 1950. These associations developed a plan to provide supplemental water to their members, limit groundwater extraction from the basins, and create a means to provide groundwater-pumping rights to users who lacked access to other supplemental water supplies. At

about the same time, the entities went to court seeking specific assignments for groundwater rights. In 1961 and 1965, the court awarded varying amounts of groundwater rights to a number of entities. During fiscal year 1997-98, 150 parties to these judgments held a total of 217,367 acre-feet of water rights in the Central Basin, and 68 parties held a total of 64,468 acre-feet of water rights in the West Coast Basin. Since water rights are property rights, they can be bought and sold.

The district's major activities now are the purchase of water to replenish the basins and clean water programs. The district annually purchases 100,000 to 200,000 acre-feet of water to be added to man-made ponds, where it gradually soaks into the underlying aquifers, or to be injected into seawater barrier wells along the coastline. Water injected into these barrier wells forms a dam of freshwater that keeps seawater from flowing into the groundwater aquifers in areas where groundwater levels have dropped below sea level. Los Angeles County operates the ponds and barrier wells, using the water the district provides.

In addition, the district operates a number of clean water programs under the authority of 1990 legislation that broadened its mission to include the detection, prevention, and removal of contaminants in the groundwater. In response to this legislation, the district established programs to monitor water quality, treat wellheads, remove contaminants, and mitigate saltwater intrusion.

THE ECONOMICS OF THE WATER REPLENISHMENT DISTRICT

To fund its operations, the district has statutory authority to set and collect a water replenishment assessment on each acre-foot of groundwater that is pumped from the basins. As part of the rate-setting process, the district conducts an annual engineering survey. It uses this survey to determine the amount of groundwater it must replenish each year. The statutes also allow the district to include in the assessment the amounts it determines necessary to fund its programs that protect groundwater quality and to fund its operating costs. The district is required to hold public hearings on its determination of the replenishment assessment and to have established the assessment by its first meeting in May.

The district's primary source of income is the water replenishment assessment. This assessment consists of three major components: funds for replenishment, funds for clean water projects, and funds for operating costs. The replenishment component has accounted for about 80 percent of the assessment over the past decade. It represents the costs of purchasing water to actively replenish the basins, based on the results of the annual engineering survey, and the costs of any capital improvement projects that will augment or improve the district's replenishment activities.

The clean water component of the assessment represents about 15 percent of the assessments levied over the past 10 years. It is intended to cover the cost of projects that will help remove contaminants from the groundwater supply. Projects range in complexity from wellhead treatment projects to the construction of a desalination facility.

The final element of the rate, the district's operating costs, averages 5 percent of the assessment. Chapters 1 and 2 discuss how the district has developed its assessment rates for the past 10 years.

Despite the replenishment assessment, the basins are still a very economical source of water. The cost of imported water can be nearly three times higher than that of groundwater. For example, for fiscal year 1998-99, the district's assessment for groundwater was \$151 per acre-foot. The cost to pump and treat the water to bring it up to drinking water standards (normally some treatment is needed), adds somewhat to the cost. In contrast, the cost of one acre-foot of imported water of drinking water quality was \$431, a difference of \$280 per acre-foot.

THE DISTRICT WILL STUDY WHETHER TO INCREASE THE BASINS' STORAGE CAPACITY

Because groundwater basins allow water to be stored in the ground for use at a later time, and because storing water above ground is increasingly expensive, the district is investigating ways to use the storage capabilities of the groundwater basins. Surplus water would be stored and used during times of decreased supplies, such as droughts. This would help provide a reliable supply of low-cost water for the region. The district believes it could increase the yield of the Central Basin by 50,000 acre-feet.

In addition, Metropolitan Water District of Southern California (Metropolitan) is interested in increasing groundwater basin yield and decreasing peak demands for imported water during times of decreased availability. Consequently, Metropolitan is looking for opportunities to store Northern California and Colorado River water in groundwater basins over a 10-year period. Further, recognizing the need to develop a groundwater management plan for Southern California, the Department of Water Resources is interested in facilitating communication among interested parties with the goal of finding additional storage capacity.

In evaluating the benefits of increasing the storage capacity of the groundwater basins, the district recognizes it must also assess the possibility of significant drawbacks, since its most recent engineering study shows that the basins are currently at almost optimal levels. For example, one consideration is how increasing underground water levels will affect the area's seismic stability, given that an abundance of underground water may act as an enhanced conduit of earthquake energy. Another consideration is whether increasing the basins' groundwater levels could create artesian wells and destabilize underground facilities.

SCOPE AND METHODOLOGY

The Joint Legislative Audit Committee asked the Bureau of State Audits to perform an audit of the district. The primary concern was whether the district had abused its statutory authority in the manner by which it sets assessments and uses public funds.

To determine the fairness of the district's water replenishment assessment, we reviewed its method of setting the assessment for the past 10 years. This analysis included a review of engineering surveys and the board's minutes and resolutions. We also compared the assessments the district collected with the amounts it spent for programs. Further, we reviewed the district board's actions in setting aside resources for long-term projects.

To assess the appropriateness of the district's contracting practices, we reviewed how the district awarded seven contracts for two of its large construction projects; however, we did not evaluate the necessity of either of these projects. As part of this work, we studied how the district planned and is managing these projects to determine if it has a way to ensure that it receives value for the resources expended.

We also reviewed the district’s administrative expenses. This included determining whether contracts for consulting services and administrative expenses incurred during the past three fiscal years complied with the district’s Administrative Code and with prudent business practices. During this testing, we investigated specific allegations raised by the ratepayers. We did not evaluate whether expenses incurred for the district’s water awareness breakfasts are in compliance with the Political Reform Act because they are the subject of an investigation by the Fair Political Practices Commission. Finally, we reviewed the district’s staffing over the past five years and compared these levels with other water agencies in Southern California. We also evaluated how the district justifies adding new staff positions, how it documents the readiness of staff for promotions, and how it determines the salaries and benefits it pays. ■

Blank page inserted for reproduction purposes only.

CHAPTER 1

The District Overestimates Its Financial Needs When It Sets Annual Assessments for Water Replenishment

CHAPTER SUMMARY

The Water Replenishment District of Southern California (the district) was established in 1959 to counteract the effects of the overpumping of groundwater from the West Coast and Central groundwater basins. The district has broad powers under its enabling statutes to perform activities that replenish the groundwater basins or clean up contaminated groundwater. To pay for its activities, it is authorized to collect an assessment on groundwater pumped from the basins. Over the last decade, the district has collected more from the replenishment assessments than it has spent, amassing a surplus that reached \$67 million by June 30, 1998. Recently, the ratepayers in the basins have criticized the district for substantially increasing its assessment through fiscal year 1996-97 and because it has not significantly reduced its rates in the past three years.

In setting its rates, the district has consistently overestimated the amount of water it will need for replenishment activities, thus inflating the estimated cost of replenishment. A historical look at actual water purchases indicates that, over the past 10 years, the district has purchased considerably less water each year than it originally estimated it would need. In setting the rates for subsequent years, however, the district failed to take into account the savings from the prior year. As a result, the district's fund balances continue to increase.

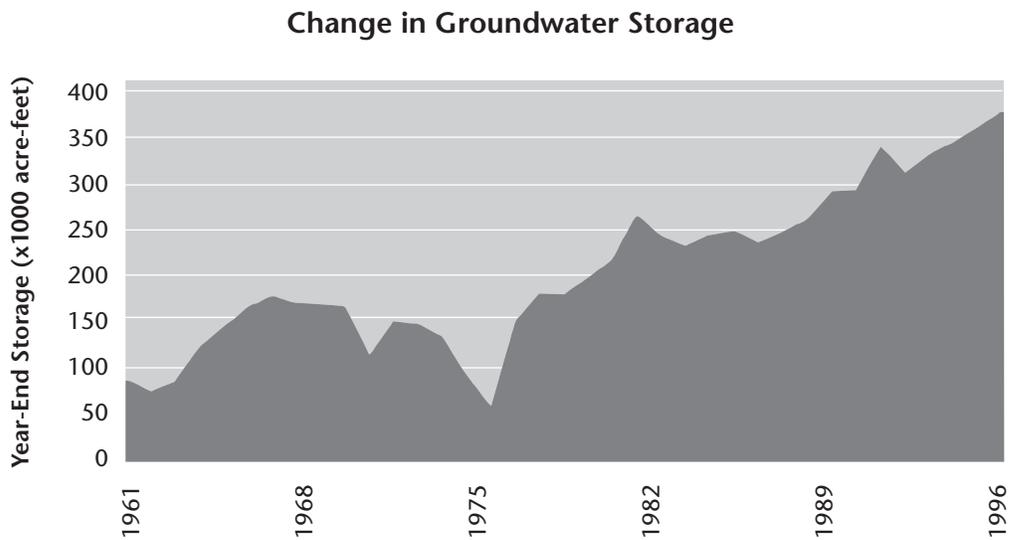
In response to concerns about its excessive fund balances, the district returned \$30 million to its ratepayers in the form of Safe and Clean Water grants in fiscal year 1998-99. However, this still leaves a \$35.9 million surplus, an amount that we find to be excessive. Moreover, the reserve policy established by the district has set aside an unjustified \$5 million in operating reserves and \$15 million in replenishment reserves. Based on the district's budget forecast for the next three years and on its expenditure history, we believe that a reserve of half these targeted figures would be more reasonable.

THE DISTRICT HAS INCREASED GROUNDWATER LEVELS, BUT IT ALSO HAS AMASSED EXCESSIVE SURPLUSES

In a 1961 study, the Department of Water Resources (DWR) estimated that groundwater in the basins declined by 901,600 acre-feet in the Central Basin between 1934 and 1956. In the 40 years since its formation in 1959, the district has been replenishing the basin to overcome this deficit and to replace any additional depletion. Through its replenishment activities, the district has been able to raise water levels in the basins to near optimum levels.¹

The district's 1999 annual report states that, based on the groundwater levels observed throughout the basins, the district expects to have adequate groundwater to meet the ratepayers' current and emergency demands. Further, the annual report states that replenishment of the groundwater has generally been in balance with the water pumped out, based on the stability of recorded water levels. Figure 2 illustrates the overall increase in groundwater levels in the basins over the past four decades.

FIGURE 2

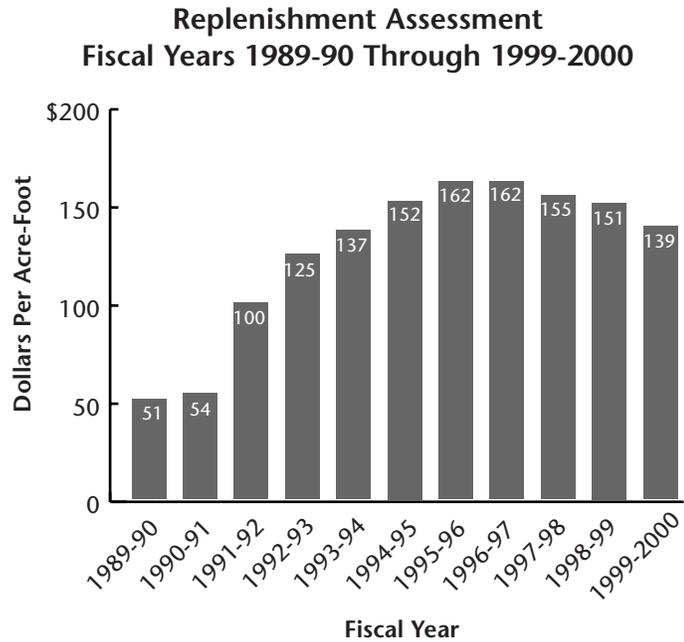


Source: Water Replenishment District of Southern California

¹ Specifically, a groundwater computer model showed that over a 26-year period from 1970 to 1996, the annual increase in the basin averaged 10,100 acre-feet per year. In other words, each year about 10,100 acre-feet of "extra" groundwater entered the basin than exited it, causing water levels to rise and reach near optimum levels.

Even though the district has restored depleted groundwater levels, it has consistently collected more than it needs for its water purchases during the past 10 years. As shown in Figure 3, the district has substantially increased its replenishment assessment since 1989.

FIGURE 3



During fiscal years 1989-90 through 1997-98, the district collected more than it spent from its Replenishment and Clean Water funds. As a result, the district finished each year with a surplus. Further, because the district did not apply enough of this surplus against the subsequent year’s assessment, the fund balances simply grew each year and by June 30, 1998, the district had accumulated approximately \$67 million in its unreserved fund balance. Of this amount, \$43.5 million was in the district’s Replenishment Fund. In response to ratepayer concerns about the size of its fund balances, the district created a Safe and Clean Water Grant program in October 1998, through which it awarded \$30 million to ratepayers that applied for a grant. The district ended fiscal year 1998-99 with retained earnings balances of \$35.8 million in the Replenishment Fund

and \$17.5 million in the Clean Water Fund.² Because the district's audited financial statements were not available to us, we were unable to determine how much of these retained earnings balances have been reserved for a specific purpose.

ASSESSMENT RATES ARE NOT CALCULATED APPROPRIATELY

As evidenced by the retained earnings balances just discussed, for more than 10 years the district has consistently overcharged the entities that use basin groundwater. This overcharging is the result of the district board's failure to establish a clear policy regarding the carryover of funds from one year to the next and Los Angeles County's overestimation of the water needed to maintain the seawater barriers.

A Consistent Policy Is Lacking for Setting Appropriate Rates and for Carrying Over Funds

The district lacks a consistent policy for using cash left over from prior year collections to offset the next year's cost of purchasing water. After estimating the acre-feet of water it needs to purchase for replenishment, the district determines the rate per acre-foot it must collect to fund the water purchases. Each year the district has had leftover funds, which could have been used to offset costs in the following year. However, the district has set its rates each year without consistently applying these carryover funds.

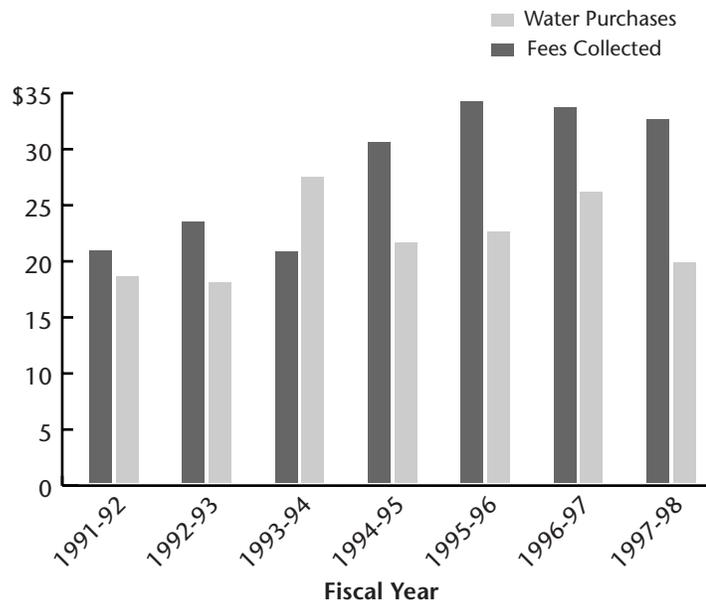
A 10-year retrospective shows that the actual quantity of water the district purchased for replenishment was consistently lower than it had estimated. The difference ranged from 8,700 acre-feet in fiscal year 1990-91 to 45,000 acre-feet in fiscal year 1997-98. Over that 10-year period, the district annually collected excess net revenues ranging from \$1.8 million to \$10.9 million. However, the district did not incorporate this excess net revenue into its calculation of the subsequent years' rates. As shown by Figure 4, with the exception of one year, revenues continually exceeded expenditures from fiscal year 1991-92 to the present.

Over a 10-year period, the district annually collected \$1.8 million to \$10.9 million more than it needed.

² We discuss the Clean Water Fund and its related programs and projects in detail in Chapter 2.

FIGURE 4

**Comparison of Revenues to Expenses
Replenishment Fund
(in Millions)**



Another cause of excess revenues is the estimate the district uses to calculate the per acre-foot rate of groundwater to be pumped (groundwater production). In fiscal year 1994-95, the district began estimating groundwater production to more closely reflect actual pumping rates, yet, in three of the past four fiscal years, the district's estimate has been at least 8,000 acre-feet lower than actual groundwater production. The effect of this difference is to inflate the per acre-foot rate, which resulted in the district's collecting at least \$1.1 million more than it had anticipated in each of the three years.

As its reserves increased, the district used few or no carryover funds in its rate-setting process.

Our analysis of the district's rates over 10 years indicates that, although revenues consistently exceeded expenditures, the district used few or no carryover funds to reduce the replenishment fee or to maintain it. For example, between fiscal years 1993-94 and 1997-98, the district's fund balance grew by \$6.7 million to \$13 million each year, but the amount of carryover funds used to offset the following year's rate was, at most, \$2 million. No carryover funds were used at all in two of those years.

Although the district did use carryover funds in some years, we could not determine, nor could the district explain, how it had figured the amount of carryover funds it used. Moreover, in its audited financial statements, the district reported substantial amounts of unreserved retained earnings in its Replenishment Fund. Even though the district sometimes uses unreserved retained earnings to help offset costs, the amount of earnings in the Replenishment Fund remains high. Thus, we conclude that the district has had more carryover funds available than it has actually used. Using these funds would have had a direct effect on the assessment rate.

Because of unusual circumstances , \$7.3 million of fiscal year 1998-99 collections will be used in subsequent years.

In fiscal year 1998-99, the Los Angeles County Department of Public Works did not allow the district to use its facilities for replenishing the basins because the county was doing construction projects at the facilities. As a result, the district had \$7.3 million it could not use to purchase water in that year. The district is planning to use this money, in addition to the money it collects in fiscal year 1999-2000, to purchase water to help compensate for the hiatus in its water replenishment activities. We also noted that when setting the fiscal year 1999-2000 rate, the district estimated that the amount of water it would purchase was more than 14,000 acre-feet less than the prior year. This has the effect of reducing the year's rate by nearly \$7 per acre-foot.

We agree that having revenues exceed expenditures is a good, conservative fiscal management practice. Further, we are not criticizing the underlying science or taking issue with the view that the district must purchase sufficient amounts of water to maintain the health of the basins. However, we believe that the district should not accumulate excess cash reserves. Rather, it should use those cash reserves to reduce future assessment rates. Although some reserves may be set aside for capital improvement projects, they are not earmarked as such in the district's audited financial statements. We discuss capital improvement projects further in Chapter 2.

In July 1999, the district's board approved a debt and financial management policy in which it committed to considering interest income, property tax revenues, and any other available funds when setting the replenishment assessment. Since it was approved after the most recent rate-setting process, we cannot conclude on the effectiveness of the district's implementation of this new policy.

To Estimate Injection Water Needs, the District Now Uses Historical Averages

As was discussed in the Introduction, another means of replenishing the groundwater supply is to inject water at the three seawater intrusion barriers. The Los Angeles County Department of Public Works (the county) owns and operates the barriers, but the district purchases the water used for injection and, until 1995, relied on the county to estimate how much water is needed to maintain the barrier wells.

Before 1995, the actual amount of water injected in any given year was consistently less than what the county had estimated because of barrier well operations and maintenance activities the county performed. During these activities, wells were shut down for an interval or were not capable of having as much water injected into them. In 1995, the district recognized the problem and began reducing the county's estimates for injection water purchases by 5,700 to 9,600 acre-feet per year to better reflect historical purchases and actual conditions.

Although the district reduced its estimate of the number of acre-feet needed for injection, its estimated cost did not decrease substantially because the price of imported water increased. Moreover, even with these reductions, actual amounts injected often were still lower than the district's forecast. Starting with the 1999 annual report, the district is estimating the acre-feet needed for injection by using recent historical averages, which should yield a more accurate cost estimate.

THE SAFE AND CLEAN WATER GRANT PROGRAM WAS CREATED TO ADDRESS CONCERNS ABOUT THE DISTRICT'S SURPLUS BALANCE

Because the district had accumulated nearly \$67 million in excess cash reserves in its Replenishment and Clean Water funds by June 30, 1998, some of its ratepayers asked for a rebate. Instead, the district board adopted a resolution in October 1998 that established a \$30 million Safe and Clean Water Grant program. The program is essentially a subsidy program that requires recipients to use the grant awards for clean water and replenishment activities. The recipients have up to three years to spend the grant money. According to the district, it has the authority to audit grantees to ensure that they use the funds for their intended purpose.

THE TARGETED RESERVE IS EXCESSIVE

The same district board resolution that established the Safe and Clean Water Grant program also established a reserve of \$20 million, which we believe is more than necessary. Specifically, the district's board resolved that the district shall at all times maintain an operating reserve of \$5 million or a reasonable amount to provide the resources necessary to operate the district for at least two months, whichever is greater. The resolution further states that the district will maintain a replenishment reserve of \$15 million to provide for the variability of year-to-year replenishment costs. In July 1999, the district board changed the name of the replenishment reserve to the "rate stabilization reserve."

Although the concept of a reserve has merit, the district cannot justify setting its operating reserve at \$5 million. We based our calculation of an appropriate reserve on the district's projected operating expenses for the next three years, minus water purchases. Since the district has also implemented a rate stabilization reserve to mitigate the effect of increased water costs, we believe the operating reserve should not include water purchases. Using the district's projected expenses minus water purchases, two months of the district's operating expenses range from \$1.7 million to \$2.4 million. Therefore, even with its two major capital projects completed and operating, two months of operating expenses would be, at most, \$2.4 million through fiscal year 2001-02.

Similarly, although we agree that it is prudent to set aside some reserve, the district's reserve policy does not substantiate its rationale for maintaining a replenishment reserve of \$15 million, nor could the district provide us with the calculation it used. Consequently, we reviewed the district's expenditure history to determine whether it had spent more than it collected in response to an emergency, such as an unanticipated demand for more water. Since fiscal year 1991-92, the district has spent more than it has collected only once. The one exception, fiscal year 1993-94, involved a decision to purchase surplus water imported by the Metropolitan Water District of Southern California. It is important to point out that the board chose to spend \$7.7 million more than the district's revenues because it wanted to take advantage of the availability of this surplus water, not because of an emergency demand for water. In all other years, the district has had sufficient revenues to fund the cost of water purchases.

A combined operating and replenishment reserve of \$20 million is twice the amount justified by projected operations.

We also compared the \$15 million to the district's estimates of water purchases for the next three years. In its fiscal year 1999-2000 budget, the district forecasted it would require \$22.9 million for water purchases, a figure that would rise to \$28.8 million in fiscal year 2001-02. The \$15 million rate stabilization reserve is 65 percent of the projected water purchases for fiscal year 1999-2000 and 52 percent of the projected water purchases for fiscal year 2001-02. Based on the district's history and the limited likelihood of significant events triggering massive price increases before its next rate-setting process, a rate stabilization reserve of \$15 million is not justified.

Clearly, a reserve fund targeted at \$20 million is excessive. We believe an operating reserve of \$2 million and a rate stabilization reserve of \$8 million, for a maximum of \$10 million in reserve funds, is a more reasonable amount.

CONCLUSION

The district has consistently spent less on water purchases than it has collected in revenues over the past 10 years, resulting in a significantly large surplus in its Replenishment Fund. This surplus has come about in part because the district has lacked a consistent policy for evaluating how much cash left over from prior year collections is available to offset the following year's cost of purchasing water. Our analysis of the district's rate over the past 10 years indicates that, although revenues have consistently exceeded expenditures, the district has used few or none of the available carryover funds to decrease the replenishment fee or to maintain it at a constant rate.

Finally, the district has chosen to keep an excessive \$5 million in its operating reserve fund and \$15 million in its rate stabilization reserve funds. Based on our assessment, an operating reserve of \$2 million is sufficient to cover two months of the district's operating costs while, based on the district's history of water purchases, we believe that a maximum rate stabilization reserve of \$8 million is more justifiable than the \$15 million established by the district board.

RECOMMENDATIONS

The district should amend the way it determines its assessment rate to require that prior year estimates be compared with the actual cost of the replenishment water it purchased. If the amounts collected exceed the amounts spent to purchase water, the surplus should be used as carryover to reduce the assessment rate in the subsequent year.

The district's board should reassess its policy regarding a prudent reserve and reduce its target reserve to \$10 million to more closely reflect its budgeted operations. ■

CHAPTER 2

The District Poorly Plans and Administers Capital Improvements and Clean Water Projects

SUMMARY

Over the past seven years, the Water Replenishment District of Southern California (the district) has collected significantly more money than it spent for its planned clean water programs. This has resulted in an ever-increasing surplus in its Clean Water Fund that totaled \$21.1 million on June 30, 1998. The district has spent only 21 percent to 54 percent of the money it has collected for these programs since it added a clean water component to its assessment rate in 1991.

The district also cannot explain what portion of the Replenishment Fund balance of \$43.5 million (as of June 30, 1998) has been set aside for capital projects. In addition to the overestimates related to water purchases discussed in Chapter 1, poor budgeting practices and the absence from 1990 through October 1998 of a strategy for implementing capital projects are the reasons for these large surpluses. Although the district developed a strategic plan in October 1998 that outlined goals and objectives, it has not developed a comprehensive strategy for implementing and managing its projects. The shortcomings in the capital project plan are, in one case, compounded by incomplete and erroneous information on the estimated costs and benefits of the project, which may render the project unfeasible.

CURRENT RATES FOR CLEAN WATER PROGRAMS ARE NOT JUSTIFIABLE

In 1990, the State Legislature amended the California Water Code sections under which the district operates. This amendment authorized the district to take any action to determine the existence of contaminants in the groundwater supply and remove or prevent them. This new authority, coupled with its original authority to replenish the groundwater supplies, gave the district broad responsibilities with respect to groundwater.

The district began to aggressively expand its operations and programs. It added engineers, hydrogeologists, and support staff to initiate and implement a new program of capital improvements intended to improve the quantity and quality of groundwater.

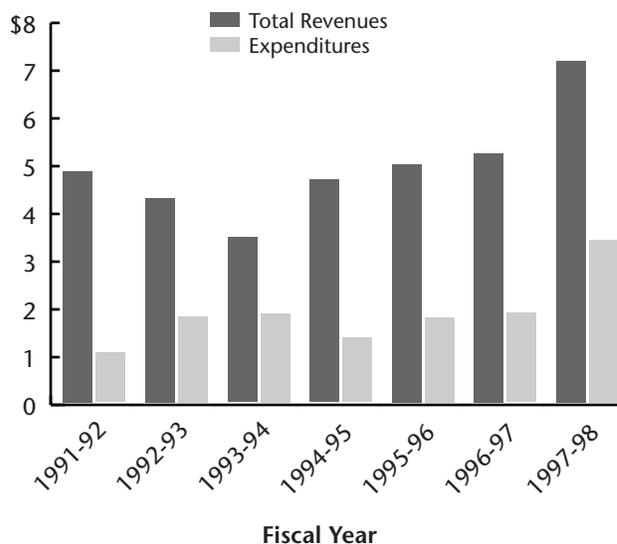
The district has failed to spend much of the money it has collected for clean water activities, amassing a surplus of more than \$21 million in its Clean Water Fund by June 1998. Failing to compare budgeted to actual expenditures, a poor budgeting practice, may partially explain why the fund has such a large surplus. Similar to the water purchase component described in Chapter 1, the district does not have a consistent policy to incorporate unused revenue when setting the subsequent year's replenishment assessment.

Millions of Dollars Collected for Clean Water Programs Remain Unspent

Each year the district includes in its budget the estimated costs for each of its clean water activities. As Figure 5 illustrates, since fiscal year 1991-92, the district has earmarked a portion of its assessment rate—ranging from \$19 to \$21 per acre-foot—for clean water programs. However, when we compared the clean water revenues to the district's expenditures for clean water programs over the past seven years, we found that the district collected \$5 to \$15 per acre-foot more than it spent.

FIGURE 5

Comparison of Clean Water Fund Revenues to Expenses (in Millions)



The district appears to have established the clean water component of its assessment without linking the rate to what it planned to accomplish in the coming year and without considering how much money it already had on hand. When asked about these differences, the district attributed them to several circumstances. It claimed it had less participation than anticipated in its Volatile Organic Compound Rebate and Wellhead Treatment programs. It also funded some work that was later taken over by another agency, and other programs have been delayed or otherwise not fully implemented. The district further noted that it used some of these excess clean water revenues to pay \$7 million of the \$30 million Safe and Clean Water grants it awarded during fiscal year 1998-99. However, even with these grants, the district had a retained earnings balance of \$17.5 million at June 30, 1999.

The district has collected from \$5 to \$15 per acre-foot more than it needed for clean water programs.

The district continued to budget large amounts for these programs every year, collecting \$19 to \$21 per acre-foot for the Clean Water Fund, even though its actual expenditures were between \$4 and \$14 per acre-foot. Moreover, between 1992 and 1997, the district used similar wording in its annual reports to describe its proposed and ongoing activities, making it difficult to determine what progress the district had actually made on these projects during these years.

CAPITAL SPENDING IS NEITHER DOCUMENTED NOR STRUCTURED APPROPRIATELY

The district also has initiated a number of major, multimillion-dollar capital improvement projects to be paid for out of its Replenishment Fund. However, it has not appropriately documented how it has funded specific projects, nor does it explain the methodology it employs to determine rate increases to pay for capital improvements. Recent plans to finance projects through long-term loans have increased the complexity of the situation.

Funding for Capital Improvement Projects Is Disjointed

The district does not specify amounts to be raised for capital projects in its resolutions. Rather, it includes funds for capital improvement projects in its total estimate for replenishment activities and, therefore, incorporates it into the replenishment portion of the total rate. Based on board resolutions, the district has authorized raising funds for capital projects since fiscal year

Capital improvement funding is not documented nor is the methodology for rate increases explained.

1995-96. We could not determine exactly how much the district has collected for capital projects because of vague and incomplete documentation. Proposed budgets and board resolutions were not linked to clearly explain how the district determined its final rate. Further, the resolutions do not provide a breakdown of the specific capital improvement projects and their costs, for which the district is collecting money. Instead, the resolutions simply state that the replenishment portion of the rate will be used to fund capital projects and other replenishment program needs, such as pipeline connection costs.

The district's audited financial statements do not report the amounts designated for capital improvement projects; all fund balances are shown as unreserved and undesignated. Consequently, we were unable to determine exactly how much was being set aside for capital projects and how the district planned to fund the projects. For example, the board adopted a resolution in 1994 approving the Alamitos Barrier Recycled Water Project (discussed later in this chapter) for an estimated cost of \$10 million, and it appropriated an initial amount of \$5 million. However, the district's audited financial statements do not show that it earmarked the \$5 million for capital projects. By not disclosing the amounts appropriated for capital projects, the district is not making this information available to the public. More importantly, the district's reporting of the amounts that have been appropriated for capital projects gives more assurance that the funds will be used for their designated purpose.

Funding of Capital Improvement Projects Is Complicated

A policy change that occurred in 1995 has complicated the picture for the district's funding of its capital improvement projects. In response to concerns raised by ratepayers, the district's board revised the way in which it will pay for capital improvements, resolving to use a combination of cash and long-term debt financing rather than paying in cash for all improvements. The proportions of cash and long-term financing will vary by project. The ratepayers recommended that the district use long-term financing to spread the cost of capital projects uniformly over the life of the project so capital costs, as well as operating costs, will be shared equally by those who benefit from the projects.

In 1998, the district hired a consultant to prepare its budget for fiscal year 1999-2000. The consultant prepared a financial action plan that presented financing options that used various

combinations of cash on hand and long-term financing for the district's projects and programs. Of the options presented, the district has decided to focus its staff and resources on two of its major capital projects that we discuss later in this chapter. Consequently, in March 1999, the district formed the Water Replenishment Financing Corporation, a nonprofit public benefit corporation, to obtain financing for its capital projects through the issuance of Certificates of Participation (COPs).

In April 1999, the district's board passed a resolution setting the replenishment fee at \$139 per acre-foot for fiscal year 1999-2000. Most of this fee will pay for estimated water purchases, although \$20 of this will pay for planned clean water programs. The district plans to fund an additional \$38.6 million of program costs and capital improvement projects through a combination of bond proceeds and accumulated funds.

Because of pending legislation, the district is unable to proceed with its planned bond issuance.

In July 1999, as the district prepared to issue its COPs, opposition from some ratepayers resulted in proposed legislation that has put this activity on hold. As of October 1999, the outcome of the legislation is uncertain and the district is unable to issue bonds. Thus, it is not clear what effect long-term financing may have on the district's rate-setting process.

POOR ANALYSES JEOPARDIZE CAPITAL IMPROVEMENT PROJECTS

The district did not have a strategic plan to build capital improvement projects until 1998. Before that, projects were prioritized depending on the wishes of the board and the vision of various general managers. With many projects in the works and no clear strategic direction, the district staff was spread thin, and projects did not get off the ground. In October 1998, the district developed a strategic plan to prioritize capital improvement project goals and objectives. It decided to focus on two major capital improvement projects: the West Coast Basin Desalination Program (the desalter project) and the Alamitos Barrier Recycled Water Project (the Alamitos project).

We have identified problems that suggest the district did not prepare sufficient analyses for either of these projects. Because of these problems, the eventual success of these projects is uncertain.

The Alamitos and Desalter Projects

The feasibility of the Alamitos project is based on the premise that it will provide a reliable source of water for the seawater barrier and will save money. The district hopes that water produced by this project will cost less than imported water purchased from others. The feasibility of the desalter project is based on the premise that the project will stop the inland advancement of and remediate a large saline plume in the West Coast Basin.

The feasibility of the Alamitos project is based on the premise it will generate savings.

When completed, the Alamitos project will take reclaimed water from the Long Beach Water Reclamation Plant, improve its quality so it meets required health standards, and then inject it into a nearby seawater barrier. The treated water will replace about half of the expensive imported water that the district purchases from the Central Basin Municipal Water District for injection into the seawater barrier, resulting in a cost savings. The Alamitos project also will provide an uninterrupted source of water for the seawater barrier, even during a drought.

The desalter project is located in the city of Torrance and is designed to stop the inland advancement of a large saline plume, shrink the plume's size, and provide a new water resource. The purpose of the desalter project is to remove saltwater from formerly freshwater wells and improve its quality so it meets the health standards necessary for distribution into public and private drinking water systems. The district is building two desalter facilities to treat 9,135 acre-feet of saltwater per year.

The district has assigned staff engineers as the project managers for both projects. These project managers are responsible for ensuring that the projects progress as planned. In general, the project managers have done a good job. They have met regularly with key consultants and contractors to represent the district's interests and to monitor the projects' progress. Both managers have reviewed contract invoices and have maintained control over each contract's budget. They have reported the projects' progress to the district's board and upper management by memorandum and presentation.

Both projects are in the early stages of construction. The earthwork for the Alamitos project began in late September 1999. The earthwork and well installation for the desalter project have been completed; the next stage is to begin constructing the desalter facilities.

The Cost-Benefit Analysis of the Alamitos Project Is Questionable

In determining the costs and benefits of the Alamitos project, the district relied on incorrect assumptions of the future cost of imported water; therefore, the economic feasibility of the project is questionable. A proper forecast of imported water costs is crucial because the success of the project is based in part on the premise that using reclaimed water is cheaper than importing water. If the district could save money with reclaimed water, it could stabilize or reduce its assessment rates.

We believe the district erred in its calculations because it did not use the long-range forecast of water rates developed by the Metropolitan Water District of Southern California (Metropolitan), the consortium of 27 cities and water agencies from which the district ultimately purchases its water. Metropolitan prepares its forecasts for agencies to use when they prepare their budgets, financial plans, and rates and when they evaluate their investments in water supplies. In 1996, it published an Integrated Water Resources Plan, which showed three projected price ranges of water—high, average, and low. This plan also noted that Metropolitan expected to charge the average range for members' water.

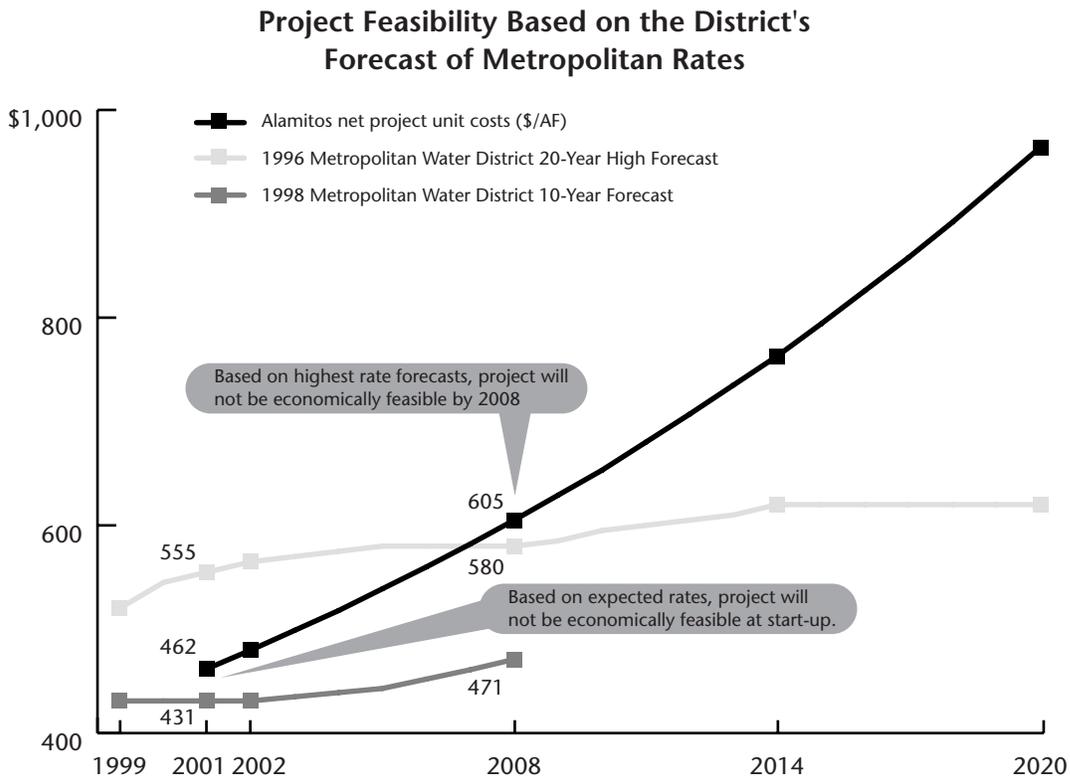
By 2020, the district's estimated \$1.2 million savings produced by the Alamitos project could actually be a \$4 million loss.

In its cost-benefit analysis of the Alamitos project, however, the district used a 4 percent inflation rate to estimate its operating costs over the life of the project. It then compared these costs to the future cost of imported water, also calculated using a 4 percent inflation rate. By the district's estimates, it would pay \$599 per acre-foot of water in 2008 and \$959 per acre-foot in 2020. Recognizing the difficulty in predicting future rates, we compared the project costs of the Alamitos project to the highest rates Metropolitan forecast for the next 20 years. Metropolitan's most expensive forecasts of water rates were \$580 and \$620 per acre-foot in 2008 and 2020, respectively. The district's forecast is \$128 per acre-foot greater than Metropolitan's forecast for 2008 and rises to \$339 more per acre-foot in 2020.

As Figure 6 shows, the differences in forecasts of future water rates can have a significant impact on the feasibility of the Alamitos project. Based on our analysis, when Metropolitan's forecast rates are substituted for the district's assumptions, the Alamitos project could lose at least \$4 million by 2020. The district projected savings of nearly \$1.2 million by 2020, savings that will not materialize because the district has

greatly overestimated the cost of importing water. The district was not aware that the cost to produce water from the Alamitos project would exceed the cost to buy water beginning in the year 2008. Over the years, this cost differential could be a constant drain on the district's resources, and the district would most likely have to raise the replenishment assessment to make up the difference.

FIGURE 6



Critical Federal Funding and Water Rights Are Pending

The district identified critical elements, such as federal funding and water rights, that it required for the Alamitos and desalter projects to be feasible. However, the district is still working to acquire these elements, even though both projects are in the construction phase. The district assumed that \$3.7 million in federal grants would be available for the Alamitos project. Based on authorizing legislation passed in October 1996, up to 25 percent of the project costs, currently estimated at \$3.7 million, will be provided by the United States Bureau of Reclamation (USBR). The funding for fiscal year 1999-2000 is a \$1.5 million line item in a federal appropriations bill. The district believes that the

USBR will continue to fund the Alamitos project in future appropriations bills. The economic feasibility of the project, as of September 9, 1999, relied on having these USBR funds as a guaranteed revenue source. The district risks having to use an additional \$2.2 million of its own if it does not obtain future USBR funds.

Although construction is underway, it is not yet known whether the district will acquire the needed water rights for the desalter project.

The district also has not clarified the question of water rights for the desalter project, even though it is a prerequisite to the district's obtaining the subsidy from Metropolitan. The district proceeded with the desalter project on the assumption that the water pumped from the basin would not be considered groundwater because of its high saline content. Because the court judgment awarding water rights to specific entities in the West Coast Basin is silent on the definition of groundwater, the district is following the precedent set by other organizations that have had similar projects. The district is preparing documents to petition the court.

Although the court has granted such petitions from parties to the judgment in the past, we are concerned that the district has not moved to clarify this issue. Further, we found that the district had not established a contingency plan to lease or purchase rights if the district's petition is unsuccessful. Current information about the cost of leasing water rights in the West Coast Basin shows that the district could face paying between \$50 to \$160 per acre-foot to lease the water rights necessary to operate the desalters.

The district has based the feasibility of the Alamitos and desalter projects on assumptions that certain events will materialize. The USBR grant and water rights issues are critical to the projects' feasibility. Both involve large sums of money, \$2.2 million for the USBR grant and more than \$456,000 per year for leased water rights, yet the district has not fully resolved these issues.

THE DISTRICT MUST THINK REGIONALLY

The court judgment assigning water rights in the Central and West Coast basins resulted in no one agency having full responsibility for managing the activities in the basins. The district is responsible for replenishing the groundwater basins, but it has no authority over the pumping that occurs there. In addition, the Central and West Coast basins are inextricably bound to

other groundwater basins in Southern California, as evidenced by the concerns over contaminants migrating into the Central Basin from the San Gabriel Basin and the fact that the Central and Orange County groundwater basins are geologically one basin. As a result, actions in any of the basins have an impact on the entire region's water supply.

Many of the projects the district wants to do will have an effect on the work of other agencies in the region.

The district would like to undertake many large projects. Some are still in the feasibility stage, and many will affect how the district replenishes the basins or how much water is stored in the basins. For example, the Chandler Quarry Groundwater Recharge project is exploring the use of a sand and gravel quarry as a recharge area for the West Coast Basin. The district is interested in this project because there are limited groundwater replenishment areas in the West Coast Basin. Another project is the Groundwater Resources Development program, which will identify water supply and demand in the basins and evaluate the effect of current and proposed projects on the water balance.

Although these appear to be worthy projects, the district must continue to work with the other regional water agencies. Some of these agencies already have prepared forecasts of the region's water needs, and many of the district's projects will have an impact on the work these agencies are performing. Regulatory agencies such as the Department of Water Resources, the State Water Quality Control Board, and the Department of Health Services also play a part in the development of additional water sources and the quality of water. A number of private and municipal water agencies in the Los Angeles area also are working to develop new sources of water and to clean contaminated water. Rather than setting its priorities independently, the district should work cooperatively with these agencies to identify regional and basin-wide priorities and to determine which agency should take the lead role in individual activities.

CONCLUSION

Since the district created its clean water programs in 1991, it has budgeted and collected funds for each of its clean water activities. However, it did not spend as much as it had anticipated, resulting in huge fund surpluses each year. In addition, the district's approach to funding capital improvement projects has been disjointed and vague. Further, its plans to finance projects through long-term financing are on hold because of pending legislation.

As a result of our review of the Alamitos and desalter projects, we conclude that the district has used faulty assumptions to forecast future imported water rates on one of its projects and has overlooked a critical cost component for each project. These failings could slightly affect the desalter project costs but could render the Alamitos project economically unfeasible before the first acre-foot of water is treated. The district should reevaluate its cost-benefit analysis of the Alamitos project and use this new analysis to determine whether it is reasonable and economically prudent to proceed with the project.

RECOMMENDATIONS

To improve the development of the clean water portion of its rate assessment, the district should implement a process for comparing revenue collected and project expenditures during the previous year. Amounts collected but not spent on clean water programs should be carried over to reduce the subsequent year's assessment rate.

To improve the means by which it determines the capital expenditure portion of its rate assessment, the district should determine the amount each capital project contributes to the annual rate. The board's resolution adopting the rate should specifically reference these amounts.

To improve its capital improvement program, the district should:

- Implement and refine a long-term plan.
- Standardize its policies and practices for preparing cost-benefit analyses and for budgeting capital projects.

Regarding the Alamitos project, the district should reevaluate the feasibility of this project using a cost-benefit analysis that includes a more reasonable assumption of future water costs.

On the desalter project, the district should move expeditiously to petition the court to clarify the water rights issue since the subsidy from Metropolitan is dependent on this action.

Finally, the district should continue to work with other water agencies in the region to identify basin priorities and to delegate responsibilities for each activity to a lead agency. ■

Blank page inserted for reproduction purposes only.

CHAPTER 3

The District Has Failed to Adequately Document and Control Administrative Expenses

SUMMARY

In addition to its problems in appropriately establishing assessment rates and in successfully implementing capital improvement projects, the Water Replenishment District of Southern California (the district) has failed to maintain sufficient controls over its administrative and personnel costs. Perhaps as the result of poor accounting and management practices over the past several years, its administration has not always documented expenses appropriately, nor has it consistently made fiscally sound decisions. Although the district's Administrative Code provides only minimal guidance to district staff when they contract for services, district staff members do not always follow these policies. For example, the district pays major expenses, such as consulting services, when no contract exists and uses retainer agreements and engagement letters as substitutes for contracts.

We found a similar laxity in the district's handling of administrative expenditures. It pays certain expenses without requiring sufficient documentation, such as invoices or purchase orders, and it sets no limits on the amount it will reimburse employees for expenses such as lodging.

Finally, although its staffing levels are not the highest among comparable water districts, the district has not adequately justified its need for some new staff positions. Further, it has not always followed its own internal policy for supporting promotions.

THE DISTRICT HAS NO COMPREHENSIVE POLICY CONCERNING CONTRACTING AND PROCUREMENT PROCEDURES

Although the district is not subject to the provisions of the California Public Contracts Code, the district's board has adopted some procurement guidance in the district's Administrative Code. This guidance, however, is minimal and does not

We found that the district often pays for services without a contract when one is required.

provide district staff with procedures to follow in several important areas of procurement. The district is revising its procurement policies, but the proposals still do not address certain areas, such as what information a Request for Proposal should include, what procedures to follow when awarding contracts, or how to proceed if a contract award is protested. Moreover, the district does not always follow the procurement policies in its Administrative Code.

Procurement Policies Are Deficient

The California Water Code does not require the district to use competitive bidding or any other specified method for entering into contracts. Nonetheless, the district's board has established a procurement policy and has included it in its Administrative Code. This policy includes only three points: It requires the district to solicit bids for services costing more than \$10,000, requires the use of a Request for Proposal to solicit bids, and states a preference that the district receive at least three bids before awarding a contract. Contracts for amounts greater than \$10,000 require board approval. This is not a sufficient procurement policy. The district, recognizing the need for additional guidance, has presented revised procurement policies for review and comment to the board's Administrative Committee.

Although the proposed policy as of October 25, 1999, expands existing policy and gives the district reasonable limits within which to act without specific board action, it is still deficient. The proposal lacks important provisions that are common to government entities and that are designed to protect a government entity if its procurements are questioned. Neither the existing policy nor the proposed policy prohibits the writing of Requests for Proposals that effectively limit the bidding, directly or indirectly, to just one bidder. Further, the district's procurement policies do not require that the solicitation documents state the criteria the district will use in selecting a winning vendor, nor do they prohibit the district from altering material factors that could affect the evaluation and selection of a vendor after the final solicitation documents are issued. Finally, neither policy indicates how the district will resolve protests of contract awards or resolve contract disputes.

The district could easily strengthen its procurement policies. One way to do so is to adopt a policy stating that the district will follow the California Public Contract Code (State Contract

Act) where it applies to local government agencies. Alternatively, the district could adopt a complete and specific procurement policy within its own Administrative Code. The district should review the State Contract Act and the procurement policies of cities and other water districts to identify the policies it should adopt.

Present Procurement Policies Are Not Followed

Merely revising the Administrative Code does not solve the problem of ensuring that the district actually follows its policies. We reviewed payments to 40 vendors made during fiscal years 1996-97 through 1998-99 and found that the district had paid more than \$2 million to 22 vendors (55 percent) for services for which no contracts existed. We also found that the district had changed the terms of three contracts without formally amending them. In all the cases, the district had received a letter from the contractor describing the changes in the scope of work but had not prepared a formal amendment as required in the original contract. Without a contract or amendment, the district has little recourse if the vendor does not provide the services the district envisioned, and it cannot ensure that the terms and conditions are mutually understood and agreed to. In addition, the district did not obtain the services of its vendors through competitive bidding as required by the district's Administrative Code, which would have provided greater assurance that the district was receiving the best value for the money spent.

Procurement practices could easily be strengthened by adopting a complete and specific set of policies.

The importance of a complete and effective procurement and contracting policy is underscored by the fact that in fiscal years 1996-97 and 1997-98, the district spent more than \$2.6 million each year on outside consulting services. These consulting services account for more than half the district's total administrative and general expenses for those two years.

Twelve of the vendors providing services to the district without a contract have provided services in more than one year. For example, between July 1996 and June 1999, the district used the same vendor to provide printing services, but it did not enter into a contract with the vendor. Over the three years, the district paid this vendor more than \$180,000 for printing services, with \$90,000 paid during fiscal year 1998-99. During the same three-year period, the district paid a consultant more than \$430,000 for legislative services without entering into a contract or using competitive bidding.

The district made a common practice of using retainer agreements, which lacked complete descriptions of work to be performed.

Of the 22 vendors that provided services without contracts, seven provided services under retainer agreements or engagement letters that the district believes substituted for a contract. The primary drawback to using retainer agreements or engagement letters is that they do not have a complete description of the work to be performed, nor do they define how long the agreement will last. Four of the vendors providing services under retainer agreements or engagement letters are law firms providing legal services, either as ongoing counsel or for litigation. In the case of litigation services, the district should have a contract with the law firm to set a limit on the amount the district is willing to spend on the litigation and to define what kinds of expenses are reimbursable. If the scope of work were well-defined, the district would have a basis on which to review the law firm's billings and to ensure that it was receiving the appropriate legal representation. Although the district cannot control the number of lawsuits that are filed against it, it can exert some control over the costs associated with these lawsuits.

We also reviewed how the district procured seven contracts related to its two major capital improvement projects. The district used competitive bidding to determine the vendor for four of the contracts and used sole source procurement for the remaining three contracts. Sole source procurement occurs when only a single vendor is afforded the opportunity to bid on the specified services. For larger contracts, the preferred method of identifying and selecting a contractor to provide services is to advertise for bids, thereby attracting several competing vendors. Competitive bidding better ensures a fair price for the services. In some instances, however, competitive bidding is not feasible. For example, if only one vendor possesses the needed expertise, the district is justified in awarding a contract to that vendor without soliciting competing proposals.

In one of the cases involving sole source procurement—the contract for the design of the treatment process for the Alamitos Barrier Recycled Water Project—the district had identified only a single vendor that could provide the specialized service it required. In another case, the district entered into a contract with an engineering firm to provide the design for and construct the facilities for the desalter project. The district justified the award of this contract without competition because the contractor had prepared the feasibility study and was familiar with what the district wanted to accomplish. However, other contractors in the area have the expertise to design and build a desalter. To receive some assurance that it had obtained good value for the resources

to be spent, the district brought in another engineering firm, also on a sole source basis (the third sole source contract we examined), to review the cost of the contract and to help negotiate a fair price. When the board approved the engineering contract, it formally set aside its Administrative Code requirement for competitive bidding. A June 16, 1999, court judgment reaffirmed the board's authority to set aside its own rules.

THE DISTRICT HAS INADEQUATE CONTROLS OVER EXPENSES

Although the district has procedures to provide some measure of assurance that payments are made only for valid expenses, the entire control structure over payments has significant weaknesses. In some instances, the district does not have policies that address these weaknesses; in other instances, the board and district staff members are not following the policies. For example, the district pays for expenses that are not documented adequately. In addition, district credit cards are used for purchases specifically prohibited in the Administrative Code and the board has not limited the amount the district will pay for certain expenses. Also, travel expense claims are not matched with approved travel requests. As a result, the district may be paying for some inappropriate or imprudent expenses.

Many Expenses Are Paid Without Required Documentation

We reviewed 92 payments totaling \$2.4 million during the period July 1996 through June 1999 and found some significant problems with 34 (37 percent) of the payments, totaling \$403,889. An additional \$47,000 of our sample related to costs for water awareness breakfasts that the board no longer holds. Although these amounts are not significant when compared with the district's expenses for its water replenishment and clean water programs, the problems indicate areas where policies and procedures can be strengthened.

During our review, the district was unable to provide any invoices or other documents to support four payments totaling \$17,750. For an additional 20 payments (22 percent), totaling \$376,600, some of the receipts were missing or the district had prepared a check request but did not have any other support, such as a quote for a deposit on a facility room rental. For one payment of

The district may be paying for some inappropriate or imprudent expenses.

\$6,777 for legal services, the district paid based on an annual billing summary that did not show the specific services provided or the rates charged.

Over a three-year period, the district paid \$404,000 in expenses that were not supported as required by its Administrative Code.

In addition, the district paid more than \$3,000 for local meals, long-distance telephone charges, and travel expenses for which the board member or district staff member did not indicate the business purpose of the expense. The district's Administrative Code requires all reimbursable expenses to include the names of the persons for whom a meal was purchased and the business purpose of the expense. Finally, we identified eight expenses totaling \$6,100 that did not appear reasonable or prudent. Specifically, the district paid \$1,000 for a table at an award dinner honoring one of its directors, four florist bills totaling \$270, \$880 to advertise one water awareness breakfast in a church publication, and \$3,300 for one board member to attend a tropical water conference in Puerto Rico.

In reviewing our sample of expenses, we noted that in at least two instances, a district employee used a district credit card to charge personal expenses. Although the employee reimbursed the district, the use of the credit card was contrary to a specific policy in the Administrative Code that prohibits the use of district credit cards for personal expenses. We identified other charges on the district credit cards used by board members and other high-level district employees for which no receipts or explanations were provided, contrary to the district's policy. Consequently, we could not determine whether the expenses, such as charges for gasoline and meals, were for appropriate business purposes or were personal expenses.

The District Has Not Placed Appropriate Limits on Some Travel-Related Expenses

In comparing the payments made, particularly for travel-related expenses, to policies set forth in the district's Administrative Code, we noted areas where the board should augment its policies and strengthen controls. Specifically, we noted that the board has not limited the amount it will pay for certain types of expenses. For example, although the Administrative Code sets a limit on the amount the district will reimburse for meals while a board member or employee is traveling, it limits the reimbursement the district will pay for lodging expenses only to "moderate" expenses. In addition, the Administrative Code does not require that board members or employees ask for a government rate when traveling or require that the employee request an

exemption from the payment of room tax. As a result, we found that the district has paid lodging rates ranging from \$99 to \$235 per night.

Moreover, district staff members do not match invoiced amounts for airline flights with expense claims filed by board members and district staff. Consequently, the district cannot determine whether the airline tickets it buys are used for approved district business. We believe the district can strengthen its policies by adopting a limit on the lodging rates it will pay and can strengthen its procedures by requiring that all expenses be supported and matched to approved travel documents.

Adequate Policies Concerning Phone Call and Conference Expenses Have Not Been Established

We also noted that the district does not have specific policies that would address other expenses we identified as questionable. These expenses include large numbers of telephone calls made while a board member or an employee is traveling and expenses for conferences in exotic locales where the specific benefit to the district is unclear.

Because invoices are not matched to expense claims, there is no way to determine whether airline tickets were used for approved district business.

The district's Administrative Code is silent on the subject of reimbursement for telephone calls. We believe the district should establish the kinds of expenses it will reimburse. Further, the Administrative Code is silent on the matter of paying for board members to attend conferences. Attendance at certain conferences clearly provides a benefit to the district, but we question whether a tropical water conference in Puerto Rico is a prudent use of the administrative funds of a water district located in Los Angeles.

The Central Basin Municipal Water District board recently voted to reimburse board members for travel only within California and Nevada. We believe the district should similarly assess its travel policies and either limit reimbursements to travel within a specific area or require that travel out of a specific area be brought before the board for action.

THE DISTRICT HAS NOT SUFFICIENTLY CONTROLLED ITS PERSONNEL COSTS

Since 1991, the district has significantly increased the number of staff it employs. We cannot conclude that the district has too many employees, but we are concerned by the lack of compelling justification for the addition of certain positions.

The Need for Additional Staff Has Lacked Sufficient and Compelling Justification

The district's board has given the general manager the authority to designate job titles and responsibilities and to hire staff. The general manager submits requests for additional positions to the board for approval. In these requests, district staff do not always provide a compelling justification for the new positions.

In 1998, the district implemented procedures for creating positions and hiring new staff members. However, when we selected a sample of nine positions that were added or upgraded since 1998, we found that the district did not always adhere to these procedures. For example, for four new positions that the board approved, we saw nothing in the district's files that adequately explained why staff had been hired or promoted. Although the board approved the new positions, the district did not have documentation to show each new position's responsibilities. Further, no documentation indicated why existing staff could not perform these tasks. In addition, the district's procedures for promoting employees include indicating in the individual's performance evaluation that the employee is ready for additional responsibilities. However, in the recent promotion of one employee, the personnel file did not include an evaluation with such a recommendation.

Salary Comparisons to Justify Salary Increases Are Not Always Performed

The district has not established a written policy for determining salary ranges for employees. The general manager recommends salary ranges for the board's approval. Proposed salary ranges are presented to the board's Administrative Committee for review and, once approved, are submitted to the board for final approval. Based on our review of the Administrative Committee meeting files, we did not see evidence that the district had always done a survey of salary ranges at other water agencies, which we believe would be a reasonable means of determining salary levels.

Further, we found no evidence that the district has always consulted outside literature, such as statewide and local salary surveys published by the Association of California Water Agencies or the Orange County Water Association, when establishing new salary ranges for staff positions. The district consulted salary surveys in the early 1990s and did some comparative analyses before establishing salary ranges for various staff positions. However, our review of the documentation reveals that in the latter half of the decade, the district did not always use salary surveys, nor did it always conduct comparative research of similar positions at other water agencies.

Although annual salary surveys are available, the district does not use them to benchmark its salaries.

To determine how the district's average salaries compare with other water agencies of similar size and within the same geographical area, or zone, we used data from the salary survey reports for 1995 through 1998 published by the Association of California Water Agencies. As shown in Appendix A, when the district's salaries are compared to the average monthly salaries for similar positions within its zone, the district's salaries are generally higher. We further compared the salaries for these same positions with the salaries reported by eight peer water agencies and found that, for most of its managerial and professional positions, the average monthly salaries at the district are \$800 to \$1,800 per month higher. The agencies we used for comparison are water agencies in Los Angeles and Orange counties that are similar in size and do not provide water directly to consumers, or are ones to which the district has compared itself.

Three of the nine positions we reviewed were upgrades of an existing position. Essentially, the upgrades represent increased responsibilities and, consequently, a change in title and salary. According to the district, it does not consider upgrades to be new positions because they are promotions of existing staff members. However, as a result of the upgrades, additional staff members are hired to fill the newly created vacancies. Thus, the net effect is that the number of staff is increased.

The District Has More Administrative Than Technical Staff Members

Since the establishment of the clean water programs in 1991, the number of staff the district employs has grown from 8 full-time employees to 22. In particular, the number has doubled over the past five years, from 11 in 1995 to 22 in 1999. The district's clean water programs are technical in nature and would require that the district add the expertise of engineers and

hydrogeologists versed in groundwater issues. Interestingly, however, since 1995 the district has consistently had more administrative staff than technical staff. In performing our analysis, we classified positions as administrative or technical according to the position's functions and duties. Specifically, we classified engineers, hydrogeologists, and field operations and maintenance staff as technical positions. Administrative positions included the general and assistant general managers, manager of finance and accounting, accountants, community affairs representatives, and administrative assistants.

THE DISTRICT SHOULD REASSESS ITS USE OF CONSULTANTS

Arguably, the increase in the number of district staff can be attributed to the 1990 amendment to the Water Code, which gave the district additional responsibilities for maintaining groundwater quality. However, even with its added technical and administrative staff positions, the district has increasingly been retaining the services of legislative, legal, engineering, and other general consultants.

Even after adding staff positions, the district has increased its use of legislative, legal, engineering, and other consulting services.

In fiscal year 1999-2000, the district is obtaining services from 10 consulting firms that provide lobbying and public relations services. We question the need for such a large number of lobbying and public advocacy firms. To understand the need for this many lobbyists, we reviewed the invoices and periodic reports the district has received from its lobbyists over the past three years. Our review shows the district paid these consultants monthly retainers that are not tied to specific tasks performed or hours spent working on the district's issues. Further, we found that the invoices and periodic reports from the four firms used over the past three years provide little information about the specific services they rendered.

We question the soundness of this business practice. Moreover, we believe that 10 lobbying firms is an excessive number for a district with fewer than 30 staff members. In one month alone, between July 23 and August 24, 1999, the district paid 6 of these firms \$75,000. The district should reassess its use of lobbying and public relations consultants and determine whether it is using its resources appropriately.

CONCLUSION

As this chapter has shown, the district has been very lax in documenting and controlling its administrative costs. Although some expenses are of questionable value in furthering the mission of the district, they are not significant enough to have led to noticeable increases in the assessment rates charged by the district over the past decade. As noted in the Introduction, the operational component accounts for only 5 percent of the total rate. However, we believe that the district's failure to maintain financial vigilance in its management illustrates the attitude that can result when an entity consistently has a substantial cash surplus from year to year and has not implemented effective controls.

RECOMMENDATIONS

To strengthen controls over its administrative expenses, the district's board should:

- Reaffirm its commitment to following the policies in its Administrative Code and ensure that its staff abides by its policies.
- Amend and expand its Administrative Code to incorporate additional guidelines related to contracting policies and procedures and limits on the expenses it will reimburse.
- Ensure that a valid contract is in place before paying for contracted services.
- Require that all travel expenses be supported and matched to approved travel documents.
- Limit reimbursements to travel within a specific geographic area or require that travel out of the geographic area be brought before the board for specific action.
- Reassess the need for 10 legislative and public advocacy firms.
- Direct its independent auditor, as part of its annual audit, to review the propriety of the district's operating expenses.

We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,



KURT R. SJOBERG
State Auditor

Date: December 15, 1999

Staff: Steven M. Hendrickson, Audit Principal
Nancy C. Woodward, CPA
Claire J. Hur
Jennifer Rarick
Ryan Storm

APPENDIX A

Average Monthly Salaries for Some Positions Are Higher Than At Comparable Agencies

Job Function	Year	Agencies in Zone	Peer Agencies
General Manager: Under policy of the Board of Directors, is chief executive of the agency; working through subordinate managers, is responsible for all agency activities, including design, construction, finance, operations, and maintenance.	1995	○	
	1996	●	▶
	1997	●	▶
	1998	●	●
Assistant General Manager: Under administrative direction of the chief executive, is responsible for engineering; planning; design; construction and inspection, including supervision of professional engineering and technical support staff.	1995	●	●
	1996	●	●
	1997	▶	●
	1998	▶	●
Manager of Finance and Accounting: Under administrative direction of the chief executive, is responsible for a variety of administrative service activities, which may include finance, bond sales and investments, data processing, customer service, meter reading and collections, insurance and risk management, personnel and employee relations, and purchasing.	1995	○	
	1996		
	1997	○	
	1998	○	
Office Manager/Deputy Secretary: Under general supervision, acts as secretary to the Board of Directors; prepares agendas, records meetings, maintains district records, provides office administrative support to the board, and ensures compliance with legal requirements.	1995	▶	▶
	1996	▶	▶
	1997	●	▶
	1998	●	○
Community Affairs Manager: Under administrative direction, is responsible for public information activities; may also prepare informational materials for distribution to employees or direct educational programs.	1995		▶
	1996		▶
	1997		○
	1998		▶
Engineer: Under general supervision, performs professional engineering work, which may include design, proposal review, contract administration, inspection, environmental review, and grant any right-of-way activities.	1995		○
	1996	▶	▶
	1997		▶
	1998	▶	▶
Senior Accountant: Under general supervision, performs professional and difficult accounting work including the analysis and reconciliation of a variety of financial transactions in payroll, accounts payable and receivable, and other functions.	1995		○
	1996	○	▶
	1997		
	1998		○

○ = \$1 to \$500

▶ = \$501 to \$1,500

● = \$1,501+

Blank page inserted for reproduction purposes only.

APPENDIX B

A Uniform Rate Is Required for the Two Basins

Recently, some ratepayers in the Water Replenishment District of Southern California (the district) have suggested there should be a separate rate structure for each of the two groundwater basins encompassed by the district. The rationale behind this suggestion is that ratepayers in one basin may be paying more than their share when compared to the district's expenditures in that basin. From fiscal years 1993-94 through 1997-98, the ratepayers of the Central and West Coast basins have supplied, on average, 79 percent and 21 percent respectively, of the district's total revenues. Over the same period, expenditures that specifically benefited the Central and West Coast basins averaged 52 percent and 48 percent, respectively. Thus, the district has spent a proportionately greater amount of money in the West Coast Basin than it collects from the ratepayers in that basin.

Ratepayers in the Central Basin have more adjudicated groundwater rights and, therefore, pump a greater amount of groundwater than the West Coast Basin ratepayers. The adjudicated groundwater rights in the Central Basin total 217,367 acre-feet, of which ratepayers have annually pumped an average of 174,019 from fiscal year 1993-94 to 1997-98. The adjudicated groundwater rights in the West Coast Basin total 64,468 acre-feet, of which ratepayers have annually pumped 47,396 acre-feet over the same period. So it is not surprising that a greater percentage of the district's revenue comes from the Central Basin.

Complicating the picture about the rate structure are the statutory requirements under which the district must operate and the fact that the basins are connected geologically. Section 60317 of the California Water Code requires that the district levy its assessment at a uniform rate per acre-foot on groundwater pumped from within the district. Moreover, the West Coast and Central basins are connected by a flow of groundwater. In the past, the overpumping of groundwater in the region caused both basins to experience similar problems. As noted in Chapter 1, the district's replenishment activities within its boundaries have restored the groundwater levels in both basins.

Consequently, replenishment and cleanup activities that occur in one basin can have a beneficial effect on the quality and quantity of groundwater in the other basin.

Although many of its replenishment and clean water projects result in expenditures within one basin, the effects of these activities cannot always be quantified. However, we believe the district's board should take into consideration the balance of revenues and expenditures when it deliberates and determines the projects and programs it will undertake.

Agency's comments provided as text only.

Water Replenishment District of Southern California
Robert L. Campbell, General Manager
12621 E. 166th Street
Cerritos, California 90703

December 8, 1999

Mr. Kurt R. Sjoberg
California State Auditor
555 Capitol Mall, Suite 300
Sacramento, CA 95814

Dear Mr. Sjoberg:

We appreciate the opportunity to comment on the Report prepared by the Bureau of State Audits on the Water Replenishment District of Southern California (the District or WRD). We thank the Bureau for the courteous and professional manner it brought to this assignment.

We are especially pleased that the Audit Report provides no support for the vast majority of allegations that prompted the audit in the first place. The Report finds no evidence of fraud, corruption, misappropriation of funds, misfeasance or malfeasance of office, or any instances of the District exceeding its statutory authority. Additionally, the Report does not assert that the District violated the Brown Act or any state laws or regulations that pertain to its assessment rates, its reserves, its projects, or its contracts. We further note that the Report recommends actions to be taken by the District; there are no recommendations for legislative action.

①*

We are also pleased that the Report finds the basins to be an economical source of water and that through its replenishment activities, the District has been able to raise water levels in the basins to near optimum levels. The Report provides independent verification that the District is meeting these two principle objectives.

Of the 16 recommendations in the Report, the District fully agrees with five of them, conditionally agrees with two, and disagrees with four. The remaining five recommendations reflect current District policy or practice. While we see merit in 12 of the 16 recommendations, we take exception to the findings or analyses that support many of them. In many cases, they are based on District policies or practices that have changed during the past 14 months. Further, these changes have been at the initiative of the Board and General Manager and are designed to address past criticism from the pumpers served by the District. The Report ignores these efforts and, perhaps because the Report frequently uses the present tense to describe past events, the reader is left with the impression that the findings uniformly pertain to the current operation and administration of the District, when that is not the case.

②

Additionally, we believe the substantive Recommendations of the Report pertaining to the Assessment Rate-Setting Process, the District's Reserve and Rate Stabilization Policy, and

③

*California State Auditor's comments begin on page 73.

the Alamitos Barrier Project are materially flawed and contain significant errors of fact and analysis that warrant detailed response.

In brief:

- ④ · The Assessment Rate-Setting policy is faulty based upon procedures in place during prior years. The Report makes scant reference to the fact that current procedures correct the problems with prior methods.
- The Report also recommends that excess net revenues from one year be carried forward to reduce assessment rates in the following year. This procedure is deficient when compared to the District's adopted financial management policies, which include the establishment of a Rate Stabilization Fund to provide predictable stable rates into the future. Acceptance of the Audit recommendation would lead to huge and unacceptable rate fluctuations from year to year because the WRD's needs for Replenishment water vary greatly depending on local hydrologic conditions, and would not be consistent with certain provision of our enabling legislation.
- ⑤
- ⑥ · The Report does not convey an understanding of how the Rate Stabilization Fund is to be used in conjunction with the Operating Reserve Fund. Nonetheless, the Report recommends a 50% reduction in the size of these two funds. This recommendation has been reviewed with the District's professional financial advisors and has been rejected as unsound.
- The Report uses a faulty evaluation to criticize the District's Alamitos Barrier Recycled Water Project. The Report erroneously cites Metropolitan Water District forecasts and does not consider the actual rates paid by WRD to Central Basin Municipal Water District and West Basin Municipal Water District. Based upon this erroneous evaluation and disregard of prior history, the Report suggests that the WRD evaluation of this project should presume that its costs will escalate at a higher rate than the escalation in the avoided cost for imported water. This recommendation is rejected.
- ⑦

We have organized our responses to correspond to the Chapter sequence of the Audit Report. Appendix A relating to District Salaries is addressed in our response while Appendix B pertaining to a Uniform Rate for the Two Basins is self-evident and requires no response.

Finally, we note the following factual errors:

- ⑧ · On Page 3 of the Introduction, in discussing the history of over-pumping in the basins, the Report states, "some pumps went dry." We believe the Report meant to say, "some wells went dry."

- On Page 3 of the Introduction, the Report indicates that the Central Basin Water Association joined the West Basin Water Association in 1950. In fact, the two Associations have never joined and function as separate entities today. 8
- On Page 3 of the Introduction, the Report states that during Fiscal Year 1997-98, 150 parties held a total of 217,367 acre-feet of water rights in the Central Basin. This is not correct. The number actually represents 80 percent of the total water rights (the Allowed Pumping Allocation) in the basin as prescribed in the Central Basin judgment. Since its inception, WRD has annually replenished the basin at an amount that has exceeded production, resulting in increased groundwater storage in the Central Basin. Additionally, WRD has modeled several alternatives of operational changes to examine the feasibility of increased groundwater use in the basin. Based on the results of the modeling and the current health of the basin, WRD is optimistic that the Allowed Pumping Allocation in the Central Basin can be increased to the full adjudicated amount of over 271,700 acre-feet per year. This would represent an increase of about 54,000 acre-feet per year of available groundwater. As the Introduction section of the Report states, “this would help provide a reliable supply of low-cost water for the region.” Additionally, this would reduce local dependence on expensive water imported from the Colorado River and Northern California and increase reliability of local water resources. 9
- On Page 5 of the Introduction, the Report states that the cost of one acre-foot of imported water of drinking water quality is \$431. No user of that water pays only the MWD basic commodity rate of \$431. For example, the current cost of water in Central Basin is \$455 and will increase to \$462 in January 2000. In West Basin, the current cost is \$528 and will increase to \$535 in January. Thus, the difference between the groundwater rate and the imported water rate for a Central Basin user is currently \$316; the difference will be \$323 in January. The difference in West Basin is currently \$389; it will be \$396 in January. The Report is correct in saying the basins are a very economical source of water. By incorrectly understating the actual difference, however, the Report understates just how economical groundwater is compared to imported water. 10
- On Page 10 of Chapter Two, the Report says, “The District is responsible for replenishing groundwater basins, but has no authority over the pumping that occurs there.” This is not a correct statement. In the first place, the District operates an In-Lieu Program to control pumping patterns and to minimize the cost of replenishment. Secondly, the courts have granted the District special authority to increase allowable groundwater pumping during droughts and emergencies. Additionally, the District is empowered to make determinations as to the need to exempt some groundwater pumping from the pumping limits of the adjudication and to waive replenishment assessments when groundwater production is needed to remedy groundwater contamination. And finally, WRD can take a broad range of actions to affect groundwater production including actions to limit groundwater production that would cause a spread of contamination. 11

Again, we appreciate the courteous and professional manner the Bureau brought to its work. We hope we have been helpful in bringing to them some understanding of a very complex subject.

Sincerely,

(Signed by: Robert L. Campbell)

Robert L. Campbell
General Manager

Enclosure

Water Replenishment District of Southern California

Responses to Bureau of State Audits Report

December 8, 1999

Chapter One: Assessment Rate-Setting Process and Reserves

BSA Recommendation: *“The district should amend the way it determines its assessment rate to require that prior year estimates be compared to the actual cost of the replenishment water it purchased and the cost of clean water activities. If the amounts collected exceed the amount spent to purchase water and fund clean water programs, the surplus should be used as carryover to reduce the assessment rate in the subsequent year.”*

District Response: We disagree.

④ The Audit Report (“Report”) notes that prior to the adoption of new financial policies beginning with the Financial Action Plan in October 1998, the District did not have a consistent policy for the treatment of excess net revenues from one year into subsequent years. Moreover, there were no adequate accounting procedures to distinguish and classify funds in the Reserve Fund, Rate Stabilization Fund, and Construction Fund. WRD agrees and has taken consistent measures to refine these policies since first addressing some of these issues in the Financial Action Plan. Implementation of these policies within the Accounting Department is subject to periodic reviews and modifications to ensure compliance with Board policies and pertinent accounting principles and practices. New measures include reporting cash balances in each fund separately and utilizing an accounting “flow of funds” procedure in which revenues are applied to operating expenses, net revenue shortfalls are taken from the Rate Stabilization Fund and, where appropriate, excesses are transferred into the appropriate Construction Fund (clean water or replenishment), or retained for future water purchases if the Board’s replenishment assessment resolutions provide for such purchases.

⑫ As noted in the District’s current budget and clarified in the Debt and Financial Management Policy adopted by the Board as an amendment to its Administrative Code in July 1999, the District articulated a plan to meet its expected operating obligations, fund water purchases, and finance future capital projects while drawing down retained earnings to the levels specified in the District’s Reserve Policy. Over the last 15 months, beginning with the October 1998 Financial Action Plan, WRD has implemented general financial management policies, management policies for debt and installment payment obligations, and management policies for District reserve funds, including the management of the Rate Stabilization Fund.

⑬ Our view is that these policies provide more stable, predictable rates, and more rigorous accounting of future obligations while correcting for prior year disparities in revenue and cost estimates. Further, we believe the District’s Debt and Financial Management Policy provides a superior method of managing construction and reserve funds than the methods described in the Report. Indeed, following the recommendation of applying excess net revenues from one year to reduce revenue requirements in the following year (and presumably applying net revenue shortfalls to revenue needs in the following year) would lead to wild fluctuations in future assessment rates and would preclude effective use of the Rate Stabilization Fund. Further, such a policy disregards the specific provisions of WRD’s statutory authority for current year assessments for future purchases.

BSA Recommendation: *“The district board should reassess its policy regarding a prudent reserve and reduce its target reserve to \$10 million to more closely reflect its budgeted operations.”*

District Response: We disagree.

Rate Stabilization Fund

The Report bases its recommendation on a history of fluctuation in water purchases. The analysis, however, does not fully address actual experience. The Report describes an event in 1994 in which the Metropolitan Water District (Metropolitan or MWD) offered the District discounted water service while also advising the District of the likelihood that the availability of replenishment water would be curtailed in the future due to drought conditions. As a result and in the interest of prudent basin management, the District maximized replenishment operations including increasing participation in its In-Lieu Replenishment Program. The Report states that during that experience the “board chose to spend \$7.7 million more than the District’s revenues because it wanted to take advantage of the availability of this surplus water, not because of an emergency demand for water.”

14

In making the comparison between total expenses and revenues in FY 94, the Report miscalculates how a recurrence of these circumstances would affect the WRD’s future revenues and expenses. In the current five-year water purchase forecast, the District presumes in-lieu participation of 30,000 acre-feet per year: 21,000 acre-feet in Central Basin and 9,000 acre-feet in West Coast Basin. The actual in-lieu participation in 1994 of more than 100,000 acre-feet exceeds this estimate by more than 70,000 acre-feet.

A recurrence of this experience at current rates would have the following effect:

1. Budgeted revenues would be reduced by \$9.73 million (70,000 acre-feet at \$139.00 per acre-foot); and
2. Assuming that all the additional in-lieu could be secured at the current Central Basin payment of \$135 per acre-foot (we note that in the West Coast Basin the in-lieu payment is even greater at \$192.00 per acre-foot), the in-lieu expense would increase by \$9.45 million above the “normal” trend line.

Such a recurrence of the 1994 experience in today’s dollars would require more than a \$19 million expenditure from the Rate Stabilization Fund. An \$8 million reserve as recommended by the Report would subject the pumping community to abrupt and substantial rate increases. Thus, the District contends that the \$15 million level is prudent based on actual recent experience.

15

12

Additionally, the \$15 million Rate Stabilization Fund is a key component of the strategy to manage future replenishment assessments. As noted in the Debt and Financial Management Policy Statement (Exhibit 1), the amount of this Reserve Fund is subject to review every two years with a professional consultant advising the Board. The current \$15 million level was established based on advice from PaineWebber, Arthur Andersen, Public Resources Advisory Group, PSOMAS, PBS&J, as well as with the assistance of a former Chief Deputy State Treasurer and the current General Manager of two Metropolitan Water District member agencies.

16

This consortium of finance and water experts advised that the \$15 million reserve was an essential component of the District's Financial Action Plan and contributed to the exceptionally high credit rating indicator the District has received from Moody's Investors Service (Exhibit 2). WRD has consulted with its independent financial advisor regarding a possible reduction of the Rate Stabilization Fund and was advised that lowering this reserve to \$8 million was likely increase the District's costs of future debt issuance. Failure to maintain an adequate and flexible Rate Stabilization Fund may also lead to lost opportunities to maximize use of lower cost replenishment supplies when available, increasing reliance on more expensive replenishment methods which could also lead to higher groundwater costs.

17

We note that the Report goes into exhaustive, detailed discussion of how methods used by WRD to estimate water purchases over the last ten years have consistently overstated needs. The Report notes, but does not make clear, that in the current fiscal year the District substantially revised these methods to correct the prior estimating bias. WRD continues to review and refine these methods.

18

Finally and most significantly, we note that it would be imprudent for the District to wait until an actual emergency demand for water manifests itself before acting. A large measure of the value the District provides to the regional economy, residents and businesses, is grounded in the District's ability to ameliorate the impact such emergencies by proactive management practices. We believe the 1994 purchases the Report addresses are a good example of such management practices.

Operating Reserve

19

The Report appears to agree that an operating reserve to cover 60 days of operating expense is prudent. However, the Report states that the District should exclude water purchases from its operating costs in determining this reserve because the District separately holds a Rate Stabilization Fund to manage fluctuating needs for replenishment supplies and manage unanticipated increases in the price of replenishment water.

The District disagrees. WRD contends that it is essential to separate the Operating Reserve Fund from the Rate Stabilization Fund. The District's Operating Reserve should be available for use even when the Rate Stabilization Fund might be fully depleted (which as we indicate above, a repeat of the 1994 experience can cause.) It is the intent of the District to keep a strict

† We have not included attachments in the report; however, they are available for review at the California State Auditor's office.

accounting of fund balances in the Operating Reserve, the Rate Stabilization Fund, and the Construction Fund. In addition, the District is required to account for these three types of uses in three separate enterprise funds — Replenishment, Clean Water, and Administrative. In fact, the Board has adopted a policy that prohibits commingling the Operating Reserve and the Rate Stabilization Fund. Finally, the District is in a unique situation because it is statutorily required to set the assessment rate only once each year and cannot respond to the sudden shifts in pricing from its suppliers. In light of this constraint, the Rate Stabilization Fund simply must be adequate to support large swings in the pricing of water purchased by the District and not be burdened with water purchases that should be funded from the Operating Reserve.

Chapter Two: Capital Improvements and Clean Water Programs/Projects

BSA Recommendation: *“To improve the development of the clean water portion of its rate assessment, the district should implement a process for comparing revenue collected and project expenditures during the previous year. Amounts collected but not spent on clean water programs should be carried over to reduce the rate assessment in the subsequent year.”*

⑳ **District Response:** Please see the response to Chapter 1.

BSA Recommendation: *“To improve the means by which it determines the capital expenditure portion of its rate assessment, the district should determine the amount each capital project contributes to the annual rate. The board’s resolution adopting the rate should specifically reference these amounts.”*

㉑ **District Response:** The District will examine the technique recommended. Such a technique, however, would be quite exceptional if applied to a water agency. There is no statutory authority to proceed in the manner indicated. The enabling legislation clearly sets forth the requirements (Section 60316) to be included in the Board resolution setting the annual replenishment assessment. The District complies with the stated requirements. We believe that the current budget, which follows more usual and customary water agency practice, provides clear descriptions of the extent to which capital projects are funded from a combination of funds on hand, current revenues, and debt issuance proceeds.

BSA Recommendation: *“To improve its capital improvement projects, the district should:*

- *Implement and refine a long-term plan related to its capital projects program.”*

㉒ **District Response:** The District Board adopted an initial three-year Capital Improvement Plan as part of its Financial Action Plan in October 1998 (Exhibit 3). The Financial Action Plan (Exhibit 4),
♦ further refined after an extensive public participation process, was formally adopted by the Board in April 1999 as part of the FY 1999-2000 Budget and Multi-Year Forecast (Exhibit 5).

- *“Standardize its policies and practices for preparing cost-benefit analyses and for budgeting capital projects.”*

District Response: The District regularly conducts financial and economic evaluations of its capital projects. Furthermore, WRD policies and procedures are consistent with the requirements of all funding agencies. In the last year, the District substantially improved its budget process.

† We have not included attachments in the report; however, they are available for review at the California State Auditor’s office.

BSA Recommendation: *“Regarding the Alamitos project, the district should reevaluate the feasibility of this project using a cost-benefit analysis that includes a more reasonable assumption of future water costs.”*

District Response: We disagree. The Report alleges that the Alamitos Barrier Recycled Water Project is poorly planned and financially unsound. This is not the case. Exhibit 6 clearly identifies the steps taken by the District in an exhaustive planning effort. The Report also recommends a re-examination of the economics of the Project. The District rejects the conclusions and recommendations of the Report pertaining to the Alamitos Barrier Recycled Water Project. (23)

The Report’s criticism of the District’s evaluation of the project is based on a flawed analysis of future imported water costs as described below.

The Report misinterprets rate forecasts from the Metropolitan Water District and does not fully evaluate how future cost escalation affects project economics. The Report cites forecasts from the MWD 1996 Integrated Resources Plan (IRP). Those forecasts were fully reviewed by WRD in conjunction with the initial feasibility study and the District further evaluated decades of experience with MWD comparing estimates of rates with actual experience, as well as the changing manner in which MWD sets its rates.

Metropolitan Water District has a variety of rates and charges, including the connection maintenance charge and the Readiness-To-Serve (RTS) charge. The rate forecasts from 1996 also envision the collection of “New Demand Charges.” Metropolitan’s efforts to diversify its revenue sources and stabilize fluctuations in revenues have the effect of reducing the future commodity rate it could charge. However, increases in other rates and charges by Metropolitan have the ultimate effect of increasing the final price paid by WRD. On page 4-15 of the 1996 report, Metropolitan notes that on average the “effective rate” is expected to increase by 3.3% per year, varying in different areas, whereas on page 4-23 Metropolitan describes an escalation of O & M costs at 3% per year.

The Report cites Metropolitan’s forecasts of effective rates but does not recognize the effective rate for barrier deliveries. Because barrier water constitutes a significant portion of WRD’s water purchases, failure to include this rate in the assessment of future water rates naturally yields incorrect (and low) projections of future prices. The range in Metropolitan’s effective rate described in Figure 4-8 of the 1996 IRP report, (as cited in the Report) refers to the average effective rate for all classes of water service including discounted service for agricultural and seasonal storage service. The forecasts for commodity rates for treated water cited in table 4-4 of the 1996 report are, by coincidence, close to the average effective rates for all classes of MWD water service. (23)

The Report suggests that WRD did not consider the MWD forecasts and that is flatly incorrect. To the contrary, WRD carefully evaluated Metropolitan’s forecasted rates to determine if they would change under real (inflation adjusted) terms. Indeed, the 1996 forecast

clearly suggests that the future barrier rate would escalate at 110% of the assumed rate of inflation.

WRD carefully evaluated how the costs of the Project compared to the current cost of imported water. In current, constant dollars the Project would achieve a break-even (with an MWD Local Resources Program (LRP) subsidy of \$209/acre-foot). With consistent escalation of project costs and avoided costs, the Project would retain this relationship over time.

24

The District has performed 25-year forecasts of the financial performance of the Alamitos Barrier Project in escalated dollars. The forecasts allowed the District to estimate the financial assistance required of MWD to meet a break-even point as compared to the continued purchase of Metropolitan-supplied water. Unfortunately, the Report mistook this financial evaluation for an economic evaluation of the Project. In WRD’s evaluation, we assumed that all costs relative to the Project would escalate at an inflation rate of 4%. That is to say, the future operating costs for the Alamitos Recycled Water Project (labor, energy, chemicals, maintenance, etc.) were estimated to escalate at the inflation rate, and the avoided cost for imported water would also escalate at the general rate of inflation.

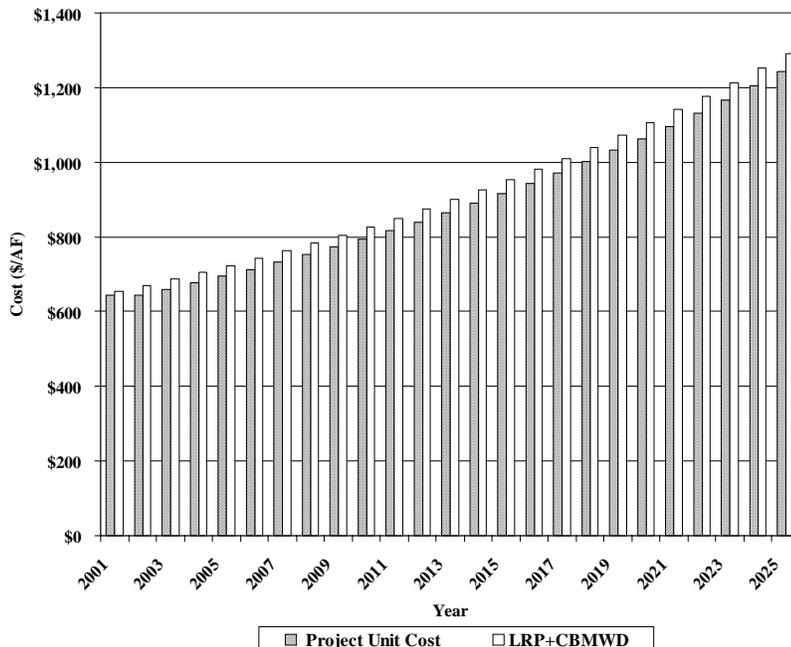
25

The Report reached erroneous conclusions about the future economics of the Project by detailing comparisons of the District’s assumed project costs at 4% escalation compared to MWD costs (incorrectly cited) at 3% escalation. If we were to adjust the WRD forecast of project costs to 3% escalation to be consistent with the MWD 1996 assumption, virtually all of the audit findings of future disparity would go away. This is demonstrated in the following figures.

Figure 1 describes how the Alamitos Project unit costs in escalated dollars compare to the

Figure 1

**Alamitos Barrier Project vs. Imported Water Costs
4 Percent Price Escalation (Basecase)**



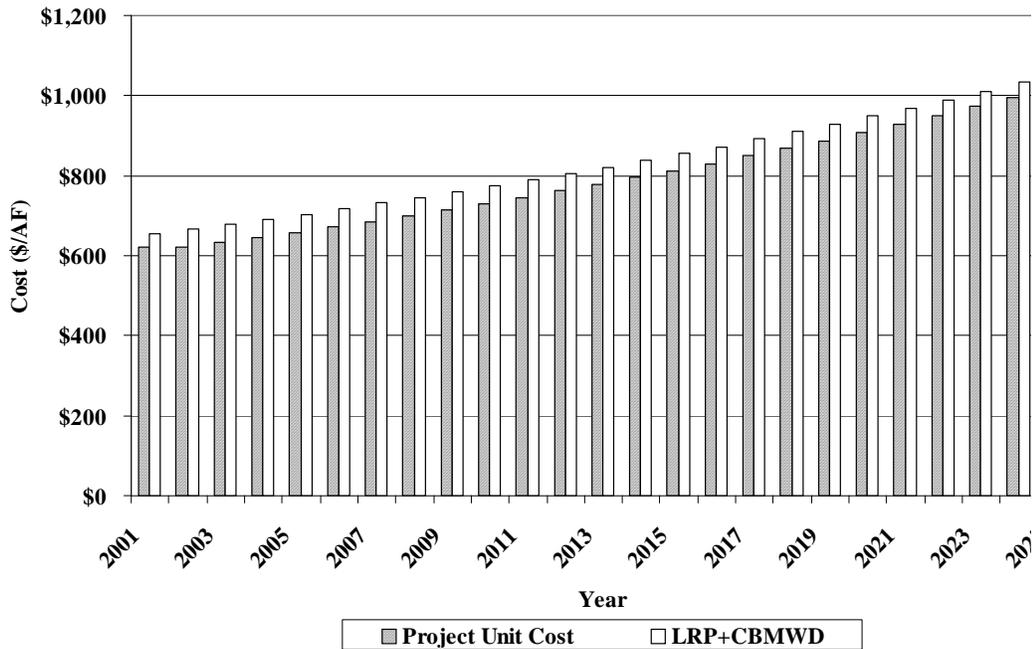
future price of imported water after adjustment for the Metropolitan Local Resources Program funding contribution to the project. In this Figure, the imported water rates and the operating costs for the Alamitos Barrier Recycled Water Project are escalated at a consistent 4% per year. These are the assumption used in the financial analysis used to support the MWD Local Resources Program request for funding assistance.

25

Figure 2 describes how the Alamitos Project's unit costs in escalated dollars compare to the future price of imported water when both forecasts are adjusted to the 3% cost escalation rate

25

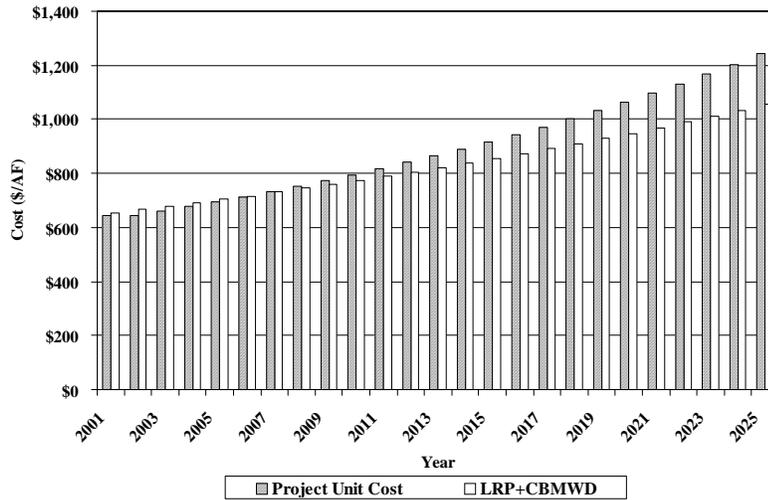
Figure 2
Alamitos Barrier Project vs. Imported Water Cost
3 Percent Price Escalation



assumed in the 1996 Integrated Resource Plan report. In this figure, the price of imported water is escalated at only 3% per year, not the 3.3% per year projected in the Integrated Resources Plan. As shown in the figure, the relationship between project unit costs and avoided imported water purchase costs is virtually unchanged from the base case relationship described in Figure 1. If we went further and assumed that MWD rates would escalate at the 3.3% cited in the 1996 report, and that WRD project costs would escalate at only 3% per year, the Project would consistently improve relative to imported water costs.

Figure 3 describes how the Alamitos Project's unit costs in escalated dollars compare to the future price of imported water utilizing the assumptions consistent with those in the Report. In this figure, the Project's operating costs are escalated at 4% per year while imported water costs are escalated at 3% per year. As is always the case when using differential escalation rates, the costs escalating at a higher rate invariably create a substantial cost differential over time. We have not shown, but it should be obvious to the reader, that if we assumed a 3% escalation of project costs and a 4% escalation of imported water costs, we could talk about a perceived cost savings from the Project over time.

Figure 3
Alamitos Barrier Project vs. Imported Water Cost
4 Percent Escalation of Project Cost 3 Percent Escalation of Imported Cost



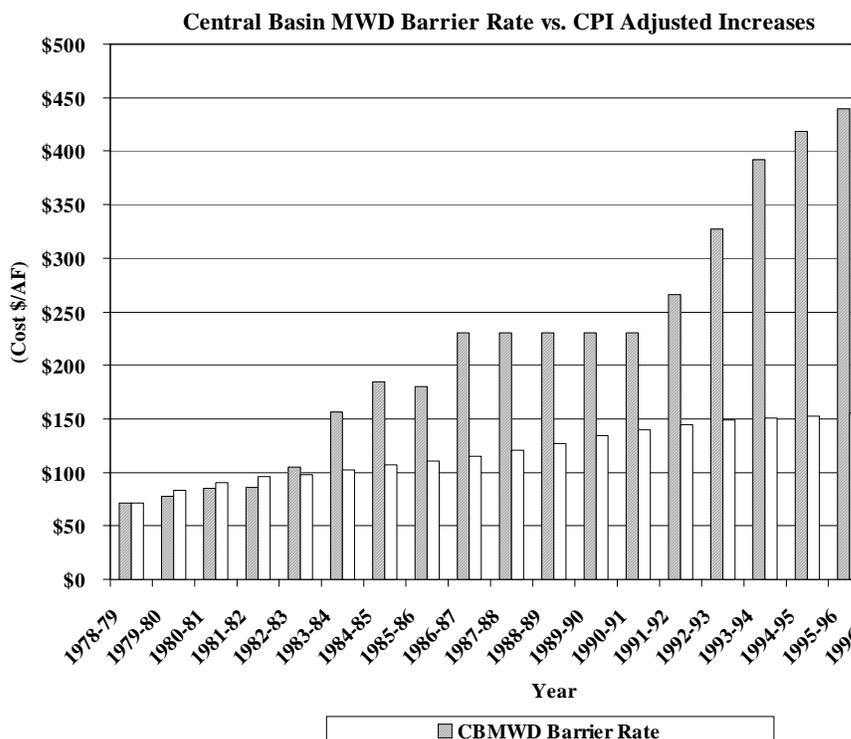
25 The Report’s comparison of 3% MWD price escalation to 4% project cost escalation is fundamentally flawed.

7 In citing the MWD forecasted rates, the Report also fails to recognize that the District does not buy water directly from the Metropolitan Water District. In fact, WRD buys water from MWD member agencies that add surcharges to the rate to cover their own costs and to translate the Readiness-To-Serve and other non-commodity charges of Metropolitan into an effective rate to WRD. Presently, the District pays a \$24 per acre-foot surcharge to Central Basin Municipal Water District. In Figure 7 of the Report, the combined effect of the error of failure to recognize the effective MWD rate and the Central Basin surcharge leads the Report to conclude that when the Alamitos Barrier Project goes on line it may have a unit cost greater than the MWD rate, which, the Report states, is forecast to be \$431/acre-foot. In fact, the Central Basin rate is already \$455/acre-foot and will increase to \$462/acre-foot on January 1, 2000. Moreover, MWD last month adopted Revenue Requirements for next fiscal year indicating that it will raise the RTS charge by another \$7/acre-foot in 2001.

In addition to evaluating the forecasts that MWD prepares, it is also appropriate to evaluate history. Since the Alamitos Barrier injection well system was constructed, Central Basin Municipal Water District’s rate for treated water for the Barrier has consistently escalated at substantially above the general rate of inflation. Figure 4 compares historic price increases to the Los Angeles Region Consumer Price Index.

In contrast to the historic experience, the District has assumed that, in the future, Central Basin’s rate increases will only be equal to the general rate of inflation. District staff has sought guidance from a number of financial advisors regarding this assumption. Those advisors include

Figure 4



Metropolitan Water District’s independent financial advisor, Public Resources Advisory Group; one of Metropolitan’s investment bankers, PaineWebber; and the consulting advice of PSOMAS and Associates, Metropolitan’s current facilitator for its strategic planning exercise.

In reviewing the prior rate increases by Central Basin MWD, it is also important to note that Central Basin has subsidized its commodity rate for barrier water by collecting a portion of the Metropolitan RTS charge through a property standby charge. Should this charge be eliminated, we would see an additional increase in the Central Basin MWD surcharge.

7

The Alamitos Barrier Recycled Water Project economics have already undergone exhaustive review. In each stage of review, additional agencies have supported the Project and become a part of the partnership of regional agencies.

The Project will receive federal assistance from the U.S. Bureau of Reclamation because it produces an economical source of water for the Western region. The California Water Commission also endorsed the project for federal funding. In 1996, the U.S. Congress adopted the Reclamation, Recycling and Water Conservation Act. Section 128 of the law authorized federal funds for up to 25% of the Project’s construction costs.

The Energy and Water Development Appropriations Act of 2000 was signed into law on September 29, 1999 and can be found in the Federal Statutes as Public Law 106-60. The House-Senate Conference Report (House Report 106-336) contained a \$1.5 million appropriation for the Project.

25

The Report recommends that WRD re-evaluate the project economics. We reject the recommendation as unwarranted and not supported by the facts. The Project is environmentally sound and economically sensible. Additionally, as noted in the Report, the Project is presently under construction. Currently, more than 25% of the total Project budget has been committed to design, equipment procurement, and on the initial phase of construction. Any delay in completing the Project will increase its ultimate cost.

WRD’s regular evaluation of the Project supports the fact that the Project achieves an approximate break-even cost when compared to the historical practice of purchasing imported water. At the break-even point, the WRD gains the following advantages:

- The Project improves the reliability of the District’s replenishment supplies during future drought.
- The Project diversifies the WRD’s protection against future risks associated with the use of imported water.
- The Project advances state-of-the-art water recycling technology to the benefit of agencies within and surrounding the WRD service territory.
- As part of the preferred resource mix, the Project lowers Metropolitan’s future costs and thereby lowers the cost of imported water purchased by WRD.
- The Project increases investment in the WRD service area instead of in projects in other parts of the state.
- The Project enables future expansion of the facility at even lower unit costs than the initial phase of construction.
- The Board has elected to design the facility to enable public education on groundwater issues consistent with the WRD mission to educate its constituents.

The discussion of rates and charges of MWD and Central Basin MWD for service to the seawater barriers prompts the WRD to make the following observations.

26

- WRD faces increases in costs from both MWD and its member agencies. The District is subject to pricing decisions driven by the needs of other public agencies. As a “captive” buyer of water from MWD member agencies, WRD is unable to seek economically attractive alternatives for imported water purchases. The result is that the District functions as a “financing” conduit for other public water agencies in financial crises. Under these circumstances, the WRD becomes a target because the public remains unaware of the origin of the ultimate increases to water prices.

- WRD is too vulnerable to increases in these surcharges. Some diversification of risk is warranted. WRD’s capital improvement program is driven by, among other considerations, the need to decrease its total dependency on monopolistic practices by its suppliers of imported water. Without the ability to diversify sources of water, WRD remains captive and unable to make decisions based on economic considerations and its desire to perform its functions in the most effective and efficient manner.

27

BSA Recommendation: “On the desalter project, the district should move expeditiously to petition the court to clarify the water rights issue since the subsidies from the Metropolitan Water District are dependent on this action.”

District Response: The Report notes that action of the court is needed to obtain an exemption for extractions for the Desalter projects. The District’s General Counsel has advised the WRD staff that the pumping of brackish water for the Desalter Project does not require exercise of a water right. Nonetheless, the District intends to petition the court shortly. Since the court previously granted a similar exemption for the C. Marvin Brewer Desalter Project, the District expects this exemption to be granted by the court consistent with our interpretation of the court judgment on water rights.

In the theoretical alternative, if the District had to obtain existing water rights for the Desalters thereby necessarily reducing extractions by other pumpers, there would be three cost impacts.

First, such an event would reduce revenues the District receives from the pumpers from whom the rights were obtained. Second, it would require the District to incur the cost of obtaining the water rights. Third, it would reduce the District’s obligations for injection water from existing forecasts. The effects of this series of events in current dollars are summarized below:

28

Revenue Reduction	=	\$139	/	AF	
Rights Purchase	=	\$200	/	AF	(Approximation based upon amortization of \$2,750/AF assumed purchase price)
Injection Avoidance	=	\$528	/	AF	
Net Savings	=	\$199	/	AF	(Approximately)

Thus, contrary to the Report’s representation, if the District had to obtain water rights, that eventuality could reduce the future budget expenses below those in the existing budget. However, it is likely that the District would lose the MWD subsidy for the Project if it requires use of existing water rights. The subsidy amounts to \$960,000 per year or \$105/AF on extractions.

28

If the District is incorrect and the Desalters do require the use of water rights it would have a minimal though likely positive impact on the District's net income in the future. The District believes it may be possible to obtain water rights in the future and reduce the costs for replenishment below the \$528/AF assumed in the District's budget and still keep the MWD subsidy. WRD is diligently pursuing this option as noted in the General Manager's presentation of the current year's budget to the Board. The District's more conservative assumptions are contained in the budget.

BSA Recommendation: *"Finally, the district should continue to work with other water agencies in the region to identify basin priorities and to delegate the responsibilities for each activity to a lead agency."*

♦ **Response:** We agree and as the Report indicates several times, we already do. Extensive examples are cited in Exhibit 7.

† We have not included attachments in the report; however, they are available for review at the California State Auditor's office.

Chapter Three: Management Policies and Practices and Administrative Procedures

BSA Recommendation: *“To strengthen controls over its administrative expenses, the district board should:*

- *Reaffirm its commitment to following the policies of its Administrative Code and ensure that its staff abides by its policies.”*

District Response: We agree.

- *“Amend and expand its Administrative Code to incorporate additional guidelines related to contracting policies and procedures and limits on the expenses it will reimburse.”*

District Response: The District is currently considering new policies and procedures relating to contracting and procurement. The Board and District General Manager have directed District Counsel to revise the proposed policies to include the suggestions in the Report, plus additional policies.

- *“Ensure that a valid contract is in place before paying for contracted services.”*

District Response: We agree and that policy has been implemented.

- *“Require that all travel expenses be supported and matched to approved travel documents.”*

District Response: This recommendation is currently the policy of the District.

29

- *“Limit reimbursements to travel within a specific geographic area or require that travel out of the geographic area be brought before the board for specific action.”*

District Response: The District will consider this recommendation.

- *“Reassess its need for 10 legislative and public advocacy firms.”*

District Response: The District routinely assesses its resources relative to its needs. The District retained these resources for specific tasks for a prescribed period of time.

- *“Direct its independent auditor, as part of its annual audit, to review the propriety of the district’s operating expenses.”*

District Response: We agree that the District’s auditor is required to review all District expenses. We disagree, however, that it is the function of the District auditor to determine the “propriety” of expenses. Propriety is a function of Board action, i.e., what policy is set for

specific matters consistent with applicable law. Thereafter, the auditor's function is to make certain that policy and generally accepted accounting principles are faithfully adhered to by the organization. Although we may be disagreeing over semantics, it is important we do not vest our auditor with judgments over policy determinations about what is "appropriate" for the District, thereby allowing the auditor to usurp Board responsibilities.

30

Appendix A: Salary Comparisons

The auditor compares the salary of individual staff positions and notes that some positions are above the mathematical average salary of equivalent positions in the ACWA salary survey. (Notably the other positions must be below average.)

The District routinely reviews the ACWA salary survey to determine appropriate salaries for its employees. We note that all positions in the District are within the salary ranges from the ACWA survey for similar positions. In addition, the District routinely surveys particular representative agencies to ensure that the District's compensation is competitive with other agencies.

31

Blank page inserted for reproduction purposes only.

COMMENTS

California State Auditor's Comments on the Response From the Water Replenishment District of Southern California

To provide clarity and perspective, we are commenting on the Water Replenishment District of Southern California's (the district) response to our audit report. The following numbers correspond to the numbers we have placed in the district's response.

- ① The district misstates the concerns that prompted this audit. The district omitted discussion of complaints that it does not adhere to its Administrative Code, that it spends money wastefully, and that it collects and holds excessive reserves. As shown in the report, we have findings and recommendations in each of these areas.
- ② Most of the changes referred to here were implemented after the district set its fiscal year 1999-2000 rates. As we note on page 18 of the report, it is premature to conclude on the effectiveness of the district's implementation of these policies.
- ③ We stand by our analyses related to these areas and address specific points in the comments below.
- ④ Our analysis of the district's rate-setting policies and practices included the district's development of its fiscal year 1999-2000 rates. Moreover, after our repeated requests, the district has provided scant evidence to convince us that the problems have been corrected. Specifically, we found that the district did not incorporate an analysis of available cash balances, which is the same criticism we had of its rate-setting practices in the prior years. Further, as noted on page 26 of the report, the district has not ever clearly described the amounts to be used for capital improvement projects. In its fiscal year 1999-2000 rate resolution and financial action plan, the amount of capital improvement projects to be funded by cash versus debt financing is unclear.
- ⑤ We believe the district is wildly overestimating the effect of our recommendation that it use excess net revenues to offset future assessments. The contention that it will experience huge rate

fluctuations presupposes that the district has grossly overcharged in the past and will not incorporate proper estimates of water costs in its calculation of its rates. Our recommendation is one element that is currently missing from the district's calculation. As we note on page 18, we do not disagree that the district must purchase sufficient quantities of water to maintain the health of the basins. However, the district has consistently made a profit from the rates it charges its ratepayers and the ratepayers should benefit from a refined calculation. Further, our recommendation does not diminish the district's flexibility in setting its rates or contradict its enabling legislation. In implementing our recommendation, the district could include an estimate of future purchases of water and show that these purchases will be funded from cash already collected.

- ⑥ We disagree with the district. We based our projection of prudent reserves on our analysis and on the district's adopted policies and are not convinced that the district needs to maintain \$20 million in reserves. As we note on page 20 of the report, the district could not provide us with its calculation supporting setting the Rate Stabilization Fund at \$15 million, nor could it provide us with the rationale used by its paid financial advisors to agree with this sum.
- ⑦ We disagree with the district's characterization of our use of the Metropolitan Water District of Southern California's (Metropolitan) forecasts as erroneous. The amount that Metropolitan charges for water comprises the majority of the amount the district pays for water it purchases from the municipal water districts. We also reviewed Metropolitan's 1991 forecast of water rates and compared its 1996 mid-range forecast to current rates. In both cases, Metropolitan's forecasts for water charges in 1999 were higher than its current rate schedule. Further, we used Metropolitan's 1996 high-range forecast in our analysis of the Alamitos Barrier Recycled Water Project (Alamitos project) to allow for the Central Basin Municipal Water District surcharge, currently \$24 per acre-foot, and other factors that could increase the future cost of imported water. Therefore, we stand by our use of the Metropolitan forecasts of the future cost of water.
- ⑧ Wording of report was changed to clarify.
- ⑨ We obtained the amount of adjudicated water rights from the Watermaster Service reports on the West Coast and Central basins. As part of the adjudication, the court appointed the

Department of Water Resources as Watermaster and the Watermaster annually reports to the court on water supply conditions in the basins.

- ⑩ We recognize that there are a variety of rates charged for water within the basin. The figures were merely used to illustrate our point, with which the district agrees, that groundwater is an economical source of water in the basins.
- ⑪ We stand by our statement that the district has no authority over pumping, since it cannot require an entity with adjudicated rights to turn off its pumps. Further, the in-lieu program to which the district refers is a voluntary program only; the district cannot compel an entity to participate.
- ⑫ The district's debt and financial management policy has been in effect only since July 1999; it was adopted after the district set its fiscal year 1999-2000 rates. As we state on page 18 of the report, because the district has not yet begun its fiscal year 2000-01 rate-setting process, it is premature to conclude on the effectiveness of the district's implementation of this policy. Further, since construction costs are already a component of the rate, we believe it unfair to automatically transfer excess net revenues to the construction fund rather than modify the rate charged to ratepayers.
- ⑬ This is a specious argument, since historically the district's water purchases have been less than estimated. The district has never invoked the provision in the water code, which allows the district to collect money in one year to fund water purchases in subsequent years. Further, because the district was not able to replenish as much water as it planned in fiscal year 1998-99, it will spend the \$7.3 million in subsequent years on water purchases. The district's implementation of our recommendation could accommodate the future purchase of water and show that the carryover of unused funds will pay for this water.
- ⑭ Since the district could not give us supporting documentation for how it calculated the \$15 million, we prepared our own analysis. In calculating the effect in current dollars of the expanded water subsidy in 1994, we also assessed the likelihood of a similar situation recurring and the district's current policies over its pumping subsidy program. We also based our determination of a prudent reserve on the likelihood of surplus water becoming available and significant price increases imposed by

the entities from which the district buys its water. Based on these indicators, we continue to believe that the district is overestimating the amount of its rate stabilization fund.

- ⑮ This calculation of \$19 million provided by the district is a weak attempt to justify \$15 million in its Rate Stabilization Fund by taking one unusual incident that occurred within the last 10 years as the basis for maintaining an imprudent \$15 million.
- ⑯ It appears that the district is basing its reserve policy on conversations with its bond sale consultants. As we note on page 20 of the report, the district could not provide us with the justification for the \$15 million amount of its rate stabilization fund.
- ⑰ The district has corrected its assumptions related to water purchase estimates, such as acre-feet of groundwater production and barrier well injection requirements, but it has not incorporated an assessment of available cash to help fund these purchases. Further, as we note on page 17 of the report, the effect of these corrections has been to increase the rate per acre-foot, which has increased its revenues annually by more than \$1.1 million over the amount the district budgeted.
- ⑱ As we state on page 20 of the report, we agree that it is prudent to have a reserve. However, we disagree with the district on the amount of the reserve and the district has not provided us with a thorough evaluation of the \$15 million rate stabilization fund.
- ⑲ We do not take issue with the existence of two types of reserve funds, but it appears that the district wants to inflate the operating reserve fund by keeping some amount applicable to water purchases. However, this is already being achieved by the existence of the rate stabilization fund. Further, that the rate stabilization fund might be fully depleted by a repeat of the expanded water subsidy in 1994 is unlikely since, as we state on page 20 of the report, the district has control over how much it can prudently make in subsidy payments. Finally, as we note on page 21 of the report, unanticipated increases in the price of water are also unlikely between its rate-setting cycles.
- ⑳ We believe that the district has a significant amount of control over its clean water programs when setting the clean water portion of the rate. However, as we state on page 25 of the report, by failing to compare budgeted to actual expenditures, the district amassed a continual surplus in its clean water fund

over a six-year period. Further, we found that the district's analysis of the fiscal year 1999-2000 clean water portion of the rate did not address the use of carryover or excess funds on hand.

- ②1 The district's contention that our recommendation is inconsistent with its statutory authority is without basis. As a component of the replenishment assessment, amounts and descriptions of capital expenditures should be included, as are amounts and descriptions for water purchases and clean water programs.
- ②2 While we recognize that the district has adopted a capital improvement plan, our recommendation speaks to the need for an implementation strategy to put into effect the goals and objectives outlined in the capital improvement plan.
- ②3 We stand by our analysis of the economics of the Alamitos project. Metropolitan's 1996 forecast of the average rate it expected to charge in 1999 is very close to the actual barrier rate it charged in 1999. This would make the average effective rate of all classes of water lower than Metropolitan's 1996 forecast. Thus, we believe our use of Metropolitan's forecast for the basis of our analysis is realistic and appropriate.
- ②4 The district provided its 25-year forecast, referred to here, in response to our request for a cost-benefit analysis for the Alamitos project. In our meetings discussing this finding on October 22, 1999, and November 16, 1999, the district did not make a distinction between a financial evaluation and an economic one. In fact, if the district does not consider this document to be a cost-benefit analysis for the project, then, to our knowledge, the district has not prepared one. This provides a further basis for our recommendation that the district standardize its policies and practices for preparing cost-benefit analyses of its projects.
- ②5 The districts discussion and charts using percentage escalators obscures the point that the Metropolitan forecast is a reasonable basis for analyzing the economic feasibility of this project. Further, we calculated Alamitos project costs using a 3 percent inflation factor for the next 20 years and compared these costs to the Metropolitan forecast. We found that the project still lost money over the next 20 years. Thus, the district has not provided a compelling argument for us to change the basis of our analysis. Consequently, we continue to have concerns over the economic feasibility of the Alamitos project.

- 26 Although the district purchases its water from other agencies, it is one of many customers of these entities. In our discussions with a variety of water suppliers, we noted that while rate increases will undoubtedly occur, these entities are cognizant of the effect of increases on their customers. Further, our discussion with these entities did not validate the district's contention that it faces imminent and substantial rate increases.
- 27 The concept of identifying and obtaining water from a variety of sources has merit. However, the district must ensure that the cost of these new sources of water is not prohibitive. Otherwise, the district will be forced to raise the rates that it charges its ratepayers, some of whom are "captive" buyers.
- 28 The district's discussion of the effect of the cost of procuring water rates on the West Coast Basin Desalination Program is misleading since it does not include all the operating costs of the project.
- 29 While the policy of the district may be to match travel invoices with approved travel documents, our audit disclosed that it was not being followed.
- 30 Our recommendation is designed to provide the district's board with a mechanism to carry out its fiduciary responsibility to ensure that district staff are following adopted policies. Since the independent auditor would be using the district's policies and Administrative Code as the basis for determining the propriety of the expense, the auditor's work would not be usurping, but rather enhancing the district board's authority.
- 31 While we mention on page 43 of the report that the district had consulted salary surveys and done analyses in the early 1990s, we also state that this practice was not always adhered to in the latter half of the decade. Thus, to say that the district "routinely" conducts salary surveys is unsupported.

cc: Members of the Legislature
Office of the Lieutenant Governor
Attorney General
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps